

HONDURAS

**REFORMING THE INSTITUTIONAL FRAMEWORK AND
CREATING INSTRUMENTS FOR IMPLEMENTING
THE POVERTY REDUCTION STRATEGY**

(1087/SF-HO)

LOAN PROPOSAL

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BASIC SOCIOECONOMIC DATA

The basic socioeconomic data for Honduras are available on the Internet at the following address:

English:

<http://www.iadb.org/int/sta/english/staweb/>

Spanish:

<http://www.iadb.org/int/sta/spanish/staweb/>

INFORMATION AVAILABLE IN THE RE2/SO2 TECHNICAL FILES

Preparation:

1. Poverty Reduction Strategy, Government of Honduras, April 2001
2. Poverty Reduction Strategy, Government of Honduras, August 2001

ABBREVIATIONS

BIP-SISPU	Integrated Bank of Programs and Projects of the Public Investment System
CB	Bank of Honduras
EDA	PRS Analysis Team
FRP	<i>Fondo para la Reducción de la Pobreza</i> [Poverty Reduction Fund]
FSO	Fund for Special Operations
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries
IDB	Inter-American Development Bank
IMF	International Monetary Fund
INE	National Statistics Institute
PCU	Project Coordination Unit
PLM	Poverty Line Method
PRGF	Poverty Reduction and Growth Facility (IMF)
PRS	Poverty Reduction Strategy
SDP	Secretariat of State in the Office of the President
SEFIN	Ministry of Finance
SETCO	Technical Secretariat for International Cooperation
SIAFI	Integrated System of Financial Administration
SIDA	Swedish International Development Agency
SIERP	Monitoring of Indicators for the Poverty Reduction Strategy
SIIF	Integrated Financial Information System
SINACOIN	National System for International Cooperation with Nonreimbursable Resources
SINEG	National Evaluation and Management System
SISPU	Public Sector Investment System
TAU	Technical Support Unit
TC	Technical Cooperation
UBN	Unmet Basic Needs
UPEG	Ministerial Planning and Management Evaluation Units
WB	World Bank

REFORMING THE INSTITUTIONAL FRAMEWORK AND CREATING INSTRUMENTS FOR IMPLEMENTING THE POVERTY REDUCTION STRATEGY

(HO-0185)

EXECUTIVE SUMMARY

Borrower and guarantor:	Republic of Honduras			
Executing agency:	Ministry of Finance (SEFIN)			
Amount and source:		US\$000		
		Tranche I	Tranche II	Total
	IDB (FSO):	15,000	15,000	30,000
Financial terms and conditions:	Amortization period:	40 years		
	Grace period:	10 years		
	Disbursement period:	2,5 years		
	Interest rate:	1% for the first 10 years and 2% thereafter		
	Inspection and supervision:	1% of the loan amount		
	Credit fee:	0.5% annually on undisbursed balances		
Objectives:	The general objective of the program is to help achieve a sustained reduction in poverty over the medium term. To do so will require effective implementation of the Poverty Reduction Strategy (PRS), which in turn will make Honduras eligible for the Highly Indebted Poor Countries initiative (HIPC). Effective implementation of the PRS will require institutional changes as well as a new approach to formulating poverty reduction policies. The specific objective of the program is to bring about these changes by: (i) creating an institutional framework that will provide a transparent and inter-institutional focus for taking decisions about resource allocation; (ii) creating mechanisms for monitoring implementation of the PRS; (iii) creating the financial instruments needed for channeling and monitoring the funds provided through debt relief; (iv) developing systems for involving civil society in PRS implementation; and (v) fostering conditions for establishing a macroeconomic framework that will protect spending on poverty reduction programs			

(paragraph 2.1).

Description:

The program employs a sector approach in support of a set of concrete measures and policy decisions focused on facilitating institutional changes that will lead to greater inter-institutional coordination, the development of instruments for physical and financial monitoring of all PRS programs, participation by civil society, and consolidating the progress that has already been achieved in the process of transforming the social sector. The program is based on a policy letter (Annex II) that sets out the overall guidelines and objectives. The specific conditions are incorporated in the policy matrix (Annex I), and will be reflected in the loan contract (paragraph 2.5).

The loan will be for a total amount of US\$30 million, to be disbursed in two tranches of US\$15 million, with no more than 12 months elapsing between the two disbursements.

The program is organized in three components:

Component I. Creating an institutional and instrumental framework for implementing the PRS. The first component will support the creation and introduction of a modern institutional framework that will facilitate intersectoral coordination among PRS executing agencies responsible for the implementation of social policies. It also calls for developing the means of monitoring PRS indicators and assessing physical and financial progress with PRS programs. This new institutional scheme, based on a comprehensive, participatory approach to planning and monitoring PRS programs, will help to improve the targeting of fiscal resources at the poorest sectors. This component relates to two aspects: an institutional aspect, i.e. technical support to the Social Cabinet, and an instrumental aspect, i.e. monitoring PRS indicators and programs (paragraph 2.13).

Component II. Financial instruments for the PRS. The government will establish financial and budgetary mechanisms to ensure transparency in raising, allocating and executing the resources earmarked for the PRS. The government will establish a financial facility, to be called the Poverty Reduction Fund [*Fondo para la Reducción de la Pobreza*, FRP] to channel all domestic and external funding in support of the PRS, SEFIN will introduce structural and classification changes to the General National Budget [*Presupuesto General de Ingresos y Egresos de la República*] so as to identify all PRS projects and programs and to distinguish those programs that will be financed with funds resulting from debt relief. This will allow for proper budgetary and financial monitoring of the PRS. The government will thereby ensure that the programs and projects

financed are consistent with its social policy and will contribute to poverty reduction, within the context of macroeconomic stability. This component relates to two aspects: design of the FRP and budgetary aspects (paragraph 2.34).

Component III. Institutionalizing citizen participation. This component seeks to institutionalize participation by nongovernmental agents in implementing the PRS, through creation of an Advisory Council (paragraph 2.46). This body will serve as a means for consultation and for monitoring PRS implementation. It will consist of representatives of government and civil society, as well as the donor community (as observers). Ensuring representation of civil society in this way will help to strengthen the growing process of democratic participation in the country, will facilitate consensus on project priorities and, most important of all, will contribute to the sustainability of the PRS.

**The Bank's
country and
sector strategy:**

The Bank's support strategy for Honduras is aimed at strengthening basic social investment programs and improving the method used for targeting scarce concessional resources at the neediest segments of the population. It also recognizes the need for improving the quality of human resources through sound investments in health and education (paragraph 1.43).

**Environmental
and social
review:**

The social aspects of this operation are positive, since the program will: (i) bring about institutional changes; (ii) create new instruments; and (iii) facilitate stakeholder participation in technical analysis and give civil society an advisory and monitoring role in the poverty reduction campaign (paragraph 3.15).

In terms of gender, targeting on poor groups, the role of the indigenous population and environmental protection, the program will reinforce arrangements already in place in other social programs and projects (paragraph 3.18).

Benefits:

The program will help Honduras to bring about a qualitative change in the way social and economic policies are formulated, by targeting them on poverty reduction in a manner consistent with the PRS (paragraph 4.5).

It will also promote use of a modern and innovative system of public administration, unprecedented in Honduras, in which the processes of decision-making, monitoring, evaluation and social communication will be based on coordinated efforts of civil society and all the institutions involved in implementing the PRS (paragraph 4.6).

Creating a framework for civil society's participation in the design, implementation and monitoring of the poverty reduction strategy will allow program planning and prioritization to reflect social needs more directly, while establishing a mechanism for ongoing social auditing of the process and its results.

The program will contribute over the short term to economic stability, and hence to the financing of the programs that form part of the poverty reduction strategy, as well as the actions that Honduras needs to take to reach the completion point under the HIPC initiative.

By stabilizing the country's external position and its public finances within a context of economic stability, PRS implementation will be facilitated and the country will be in a better position to undertake the investment in human capital needed to achieve sustainable growth (paragraph 4.8).

The changes to be made in the General National Budget will improve the allocation of resources and monitoring of programs, and will therefore have a positive impact on the efficiency of public spending (paragraph 4.9).

Risks:

Honduras is to hold presidential elections in November 2001, and it is possible that this program could encounter difficulties under a new government. The risk of noncompliance that this situation implies should be mitigated by the commitments that have been made to civil society and to the international agencies involved in preparation and execution of the PRS (paragraph 4.10).

The fact that there will be time lags in the receipt of proceeds from debt relief, from the capitalization or private-sector concessioning of public services and from concessional external resources poses a risk to implementation of the PRS, and therefore to Honduras' ability to meet the HIPC completion point. This operation will ensure continuity in the execution of the successful social programs that are now underway and that form an essential part of the PRS (paragraph 4.11).

Progress on the institutional and operational fronts to date is not sufficient to ensure successful implementation of the PRS. This program will encourage institutional reorganization that will allow involvement by civil society and those in charge of executing the PRS in identifying and selecting priority programs. The program will therefore contribute to monitoring progress under the PRS, and will enhance the transparency and accountability of government actions

(paragraph 4.12).

**Special
contractual
clauses:**

Disbursements will be made in two tranches of US\$15 million each, and will be subject to fulfillment of the prior conditions indicated in Section II of this document and summarized in Annex I (Policy Matrix). Disbursement procedures will be those for sector adjustment loans established in document GN-2001-2 approved by the Bank's Board of Executive Directors.

**Poverty-
targeting and
social sector
classification:**

This operation qualifies as a social equity enhancing (SEQ) project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704), because it is targeted essentially at supporting social sector reforms. The program in fact establishes explicit performance indicators for measuring poverty reduction and social equity enhancement (paragraph 3.16).

**Exceptions to
Bank policy:**

None.

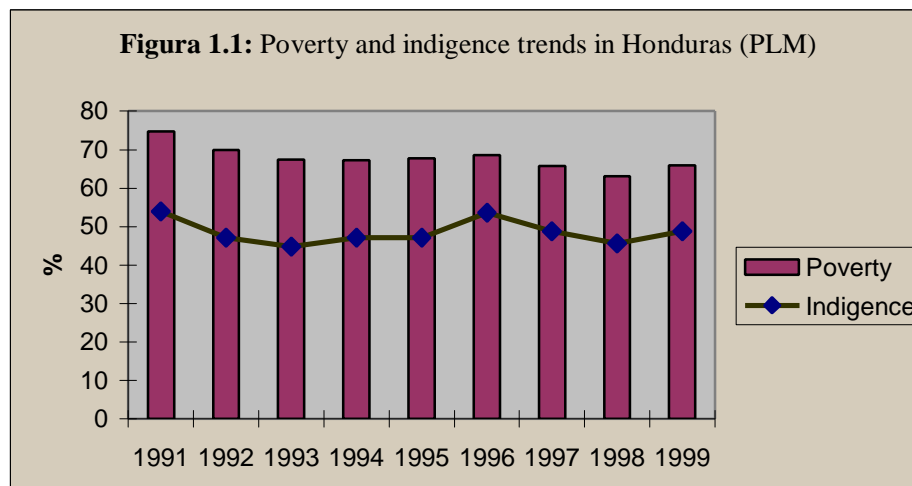
Procurement:

Not applicable, as discussed in paragraphs 3.6, 3.7 and 3.8.

I. FRAME OF REFERENCE

A. Poverty in Honduras

- 1.1 Honduras ranks as the third-poorest country in Latin America and the Caribbean, after Haiti and Nicaragua. Gross Domestic Product (GDP) per capita in 1999 stood at US\$760. Living conditions as measured by conventional social indicators are consistent with prevailing low income levels. Key poverty indicators such as life expectancy, infant mortality and the proportion of the population with water and sewer service are below regional averages. The latest available poverty measurements indicate that 66% of the Honduran population lives below the poverty line,¹ and this figure rises to 75% in rural areas. Nearly half the country's people are classed as extremely poor, or indigent.²
- 1.2 Despite the efforts of the Government of Honduras to combat poverty, the last decade saw a decline of only nine percent in the proportion of households living below the poverty line. The level of indigence was even more resistant to change: between 1991 and 1999 it declined by only five percentage points. Figure 1.1 shows poverty and indigence trends in Honduras calculated by the income-based poverty line method (PLM). The poverty level declined by seven percentage points in 1992, and showed lesser but still significant reductions in 1997 and 1998. In 1999, on the other hand, it began to rise again in the wake of Hurricane Mitch.



Source: Poverty Reduction Strategy

¹ The poverty line is defined as households where per capita expenditure is enough to meet nutritional needs, but not all the basic needs of human development.

² Households are considered to be indigent if their expenditure per capita is less than the value of the basic nutritional basket. In rural areas 61% of households fall into this category.

1.3 Government efforts to improve health and education during the 1990s were inadequate: as can be seen from Table 1.1, the key indicators improved over the past decade, but are still below average for the region. These indicators are: school enrollment rates, years of schooling, proportion of population with access to water and sewage services, child mortality and malnutrition, and life expectancy.

1.4 A determining factor in efforts to reduce poverty is economic growth, the impact of which has been limited by two factors. The first is the high level of population increase (2.7%, one of the highest rates in region), which dilutes economic growth in terms of income per capita. The second is the lack of equity in personal income distribution,³ which diminishes the impact of economic growth on reducing poverty.⁴ The Gini coefficient for Honduras, with respect to household income, was 0.54 in 1997, i.e. at the

Table 1.1: Social indicators		
Indicators	1990	1999
Gross enrollment ratio, pre-school	17.0%	38.8%
Gross enrollment ratio, primary	94.5%	97.8%
Gross enrollment ratio, secondary*	27.6%	34.7%
Illiteracy rate (>15)*	27.0%	22.7%
Average years of schooling*	3.9	4.8
No access to safe drinking water	34.0%	19.1%
No access to sanitation services	38.0%	16.9%
Infant mortality rate per 1000 live births	50.0	42.0
Child malnutrition rate		40.0%
Vaccination rate <5 years	81.8%	94.2%
Life expectancy [years]	64.9	68.8
* Latest available data are for 1998		
Source: Government departments and basic indicators for 2000.		

average for Latin America and the Caribbean, but below that of countries such as Chile (0.58) and Mexico (0.57). Economic stability, and in particular inflationary pressure, are considered as other determining factors of poverty. The decline in the inflation rate after 1992 probably contributed to reducing the incidence of poverty over the past decade (Table 1.2).

1.5 In addition to economic growth, income levels and distribution, a further factor that also contributes to reducing poverty is the amount and composition of government social expenditure. Observed trends in poverty levels, measured in terms of Unmet Basic Needs (UBN), show that investment in basic social services can result in improved living standards. Although social expenditure has been constrained by low GDP, a low volume of fiscal revenues and the payment of external debt

³ During the past decade, for every percentage point of growth in GDP per capita the poverty rate declined by only 0.65 points. The ratio for Latin America as a whole is 1:0.94, and Honduras would need to increase this ratio to at least 1:1.

⁴ Foster, James and Miguel Székely: Is Economic Growth Good for the Poor? Tracking Low Incomes Using General Means. IDB, January 2001.

service, social expenditure rose over the past decade as a percentage of the national budget, amounting to 40.7% of the budget in 2000. Yet spending levels have increased faster than the actual provision of services, reflecting wage adjustments and their influence on expenditure levels. Moreover, only 47% of social expenditure goes to basic services, which are those targeted most clearly at the poor.

Table 1.2: GDP and population growth, inflation and poverty					
	1991	1993	1995	1997	2000
GDP [%]	3.3	6.2	4.1	5.1	4.8
Population [%]	3.0	2.9	2.7	2.6	2.5
Income/capita [%]	0.3	3.3	1.3	2.3	2.9
Inflation (annual)	34	10.7	29.5	20.2	10.1
Poverty [%]	74.8	67.5	67.8	65.8	65.9

Source: UNAT

1.6 Given the lack of access to basic services and productive means, people living below the poverty line are caught in a vicious circle of malnutrition, poor health, inadequate education and marginal incomes. To escape from this trap and increase standards of living will require government intervention through investment in human capital targeted in particular at the poorest.

1.7 Poor people depend to a large extent on natural resources for their subsistence, yet the need to preserve the environment makes it advisable to restrain the use of these resources. Alternative means must be found so that the poor can make sustainable use of natural resources.

Social goals for the PRS to 2015

- a. Reduce the incidence of poverty by 24 percentage points
- b. Double pre-basic education coverage for children of 5 years
- c. Achieve a net coverage ratio of 98% in the first two cycles of basic education
- d. Increase net coverage to 70% in the third cycle of basic education (grades 7 to 9)
- e. Ensure that 50% of the labor force has completed secondary school
- f. Reduce the infant and under-5 mortality rates by half
- g. Reduce under-5 malnutrition to at most 20%
- h. Reduce maternal mortality by half
- i. Ensure 95% access to drinking water and sanitation
- j. Equalize and increase by 20% the human development index for women
- k. Implement a sustainable development strategy to reverse the loss of environmental resources.

B. The Highly Indebted Poor Countries (HIPC) initiative and the Poverty Reduction Strategy (PRS)

- 1.8 In December 1999, Honduras was declared eligible to participate in the HIPC initiative.⁵ This eligibility was based on the impact of foreign debt on the public finances of Honduras, and on recognition of the efforts that the country had made to maintain macroeconomic stability during the 1990s. Thanks to the progress achieved in economic management and the structural reforms called for under the HIPC initiative, as well as the formulation of the Interim Poverty Reduction Strategy, Honduras reached the HIPC decision point in June 2000, and the country thereupon began to receive interim debt relief.
- 1.9 The Government of Honduras submitted its full Poverty Reduction Strategy Paper (PRSP) to the Bank on 8 August 2001. As conditions for Honduras to reach the HIPC completion point, the country is to undertake a series of structural and social reforms, including satisfactory implementation of the PRS over a period of one year. Once these conditions are met, the country will receive the full benefits of debt relief. The country is expected to achieve this objective by September 2002.
- 1.10 The Government of Honduras has employed a participatory approach in preparing the PRS, and has encouraged participation by civil society, thereby securing commitment and validation by the relevant stakeholders, i.e. the beneficiaries and the international financial community.
- 1.11 The Poverty Reduction Strategy is focused on such areas as accelerated, equitable and sustainable economic growth; human capital development, primarily in the areas of education and health; reducing poverty in rural and marginal urban areas; enhancing social protection for groups identified as at risk of social exclusion; and dealing with aspects relating to sustainability.
- 1.12 The PRS envisions two types of programs and projects: those that will be financed through debt relief, in the context of the HIPC initiative, and those that are already underway, typically with international cooperation. The programs and projects now in execution are complementary to the new programs to be undertaken within the PRS framework. The strategy calls for all these programs to be conducted through measures that will ensure transparency, monitoring and citizen participation. It is essential to take advantage of the political will, determination and experience that this government has accumulated in order to make further progress in implementing the PRS and to ensure its continuity.
- 1.13 The programs and projects that make up the PRS amount to a total of US\$2.666 billion, and they will be executed over a period of 15 years. Projects now in execution already have external financing commitments, and the corresponding

⁵ Highly Indebted Poor Country.

local contribution will be financed with domestic resources. New projects will be financed from the proceeds of both conventional and HIPC debt relief, as well as from any additional financing that the country may secure.

- 1.14 Total funding to be derived from debt relief for financing the strategy amounts to US\$934.4 million (35.1% of the total PRS); project loans now in execution will provide US\$768.7 million (28.8%), and will be concentrated during the first five years of the strategy's execution. Additional financing needs amount to US\$962.4 million (36.1% of the PRS), and will be concentrated for the most part during the latter 10 years: this timing will allow for the negotiation of further financing and the generation of domestic resources to help finance the PRS. The following table shows details of the PRS financing plan.

Table 1.3: Financing poverty reduction programs and projects*								
(In millions of US\$)								
I.	DESCRIPTION							
A.	TOTAL COST							
		<u>2,001.0</u>	<u>2,002.0</u>	<u>2,003.0</u>	<u>2,004.0</u>	<u>2,005.0</u>	<u>0.0</u>	<u>0.0</u>
1.	Programs and projects in execution	266.7	214.4	89.9	74.6	62.2	60.9	768.7
2.	New programs and projects	80.2	173.5	242.1	252.6	260.7	887.7	1,896.8
B.	FINANCING							
1.	Proceeds of Debt Relief	46.3	91.0	203.9	194.5	157.3	241.4	934.4
	SES HIPC	46.0	49.5	111.6	116.6	101.8	231.2	656.7
	SES Conventional	0.3	41.5	92.3	77.9	55.5	10.2	277.7
2.	Disbursements for projects in execution	266.7	214.4	89.9	74.6	62.2	60.9	
3.	Additional financing needs	33.9	82.5	38.2	58.1	103.4	646.3	962.4
	SES External	28.8	70.1	32.5	49.4	87.9	549.4	818.1
	SES Domestic	5.1	12.4	5.7	8.7	15.5	96.9	144.3
* Estimates based on figures from SEFIN and HIPC Decision Point Document.								

- 1.15 The country faces two challenges in moving forward with PRS implementation. The first is to maintain the macroeconomic stability needed to make progress in reducing poverty. The second is the PRS operational framework, which needs to be reformed in ways that will allow for horizontal and transparent treatment of mechanisms for taking decisions and allocating resources for poverty reduction.

C. Macroeconomic setting, the program and its importance for PRS implementation

- 1.16 Honduras has made significant progress since 1990 in stabilizing its economy and in undertaking structural reforms conducive to sustained economic growth. The Honduran economy rebounded strongly in 2000, posting a growth rate of 4.8%,

together with a decline in the current inflation rate, which stood at 10.1%, the lowest since 1993.

- 1.17 Despite the deterioration in the country's terms of trade in 2000, reflecting the substantial increase in oil prices and the fall in coffee prices, rising capital account flows, resulting both from foreign investment and from external disbursements, served to strengthen the country's external position by augmenting the international reserves of the Central Bank to the equivalent of four months' imports. Despite the Government of Honduras's efforts to strengthen the public finances, the Central Government closed the year with a deficit of 4.6% of GDP. Macroeconomic performance in 2000 allowed Honduras to meet the targets for the second year of the PRGF⁶ program with the IMF.
- 1.18 According to preliminary statistics, the Honduran economy will continue to be faced with an unfavorable external environment over the period 2001-2002. Falling export prices and a slowdown in the economy of its principal trading partner, the United States, will affect export revenues, and this, together with rising imports, will increase the current account deficit from 3.4% of GDP in 2000 to 5.2% in 2001 and 6.5% in 2002.
- 1.19 Although a portion of the current account deficit on the balance of payments will be offset by expected increases on the capital account, the net international reserves of the Central Bank will remain at a level equal to four months' imports. In keeping reserves at a level that will maintain exchange market stability, the country will have the support of the IMF, the World Bank and the IDB, as well as financing from donors, who in 2001 will provide support for the final stage of the reconstruction programs.
- 1.20 For the years 2001 and 2002, the central government deficit is expected to stand at 4.5% and 2.5% of GDP, respectively. These results reflect primarily the increase in capital spending on reconstruction projects, execution of which will be speeded up in 2001 to make up for previous delays, and the increase in current expenditure resulting from statutory adjustments to wages and salaries.⁷
- 1.21 The Government of Honduras will continue its efforts to maintain fiscal discipline by improving tax administration, adjusting the public payroll and rationalizing public expenditure. As part of these efforts it will proceed further with redirecting public expenditure towards the social sectors. Social spending has in fact increased in recent years, and accounted for 40.7% of total spending in 2000.

⁶ Poverty Reduction and Growth Facility.

⁷ To compensate for the loss in real salaries, Congress approved legal statutes increasing salaries for certain occupational groups, including physicians, teachers and social and health workers. Salary increases for teachers (who represent 45% of public employees) account for most of the increase in current government expenditure over the period 1997-2001.

- 1.22 The Government of Honduras economic program for the 2001-2002 biennium will be backed by the framework negotiated as part of the third year of the IMF program, which is described in the section on the economic program.
- 1.23 While Honduras benefited from debt relief in the context of Paris Club negotiations and debt service financing by the CAETF⁸ in 2000, the country has so far received only a portion of the interim debt relief envisioned in the HIPC initiative, inasmuch as some financial institutions have been late in giving effect to the initiative.
- 1.24 The time lag in the receipt of proceeds from debt relief has increased pressure on the Government of Honduras finances during 2001, and has reduced the resources available for poverty reduction programs. This situation will lead to a PRS financing gap of US\$33.9 million in 2001 and US\$82.5 million in 2002,⁹ most of which will be covered by external financing.
- 1.25 A shortfall in resources for financing the PRS would jeopardize the country's chances of reaching the HIPC completion point since, as noted earlier, Honduras is required to make progress in executing social programs and implementing the PRS for at least one year after its submission.
- 1.26 Funding under the proposed program will help to consolidate the country's external position, while providing financing for priority social programs and thereby supporting implementation of the PRS during 2001 and 2002.

D. The institutional setting: the need to develop a suitable operating framework for implementing the PRS

- 1.27 Implementing the PRS constitutes a great challenge for the Government of Honduras. Executing, monitoring and evaluating a series of programs in sectors ranging from water and sanitation to the inclusion of indigenous peoples, within a participatory context, is a difficult task.
- 1.28 Successful implementation of the PRS will require the development or adoption of an efficient and transparent operating framework containing, as a minimum, a suitable institutional scheme; a technical support structure for taking decisions on targeting allocations; mechanisms for monitoring poverty indicators and the PRS and physical and financial progress with PRS programs; and channels for civil society participation.
- 1.29 **The institutional framework.** The intersectoral nature of the PRS requires a horizontal structure at the highest political levels for planning and taking decisions.

⁸ Central American Emergency Trust Fund.

⁹ Preliminary estimates.

This structure must include the Ministries for the institutions with primary responsibility for implementing the PRS.

- 1.30 The Social Cabinet,¹⁰ created by Executive Decree in 1999, is a decision-making body responsible for coordinating social policies. Despite the existence of this body, social policies are still highly fragmented, reflecting essentially the lack of interinstitutional coordination. The need for coordination will become even more evident with implementation of the PRS, since programs and projects will become increasingly diverse. For example, the productive projects that are so important for reducing poverty will now be added to the portfolio considered by the Social Cabinet. There is an immediate need therefore to strengthen the Social Cabinet and/or its supporting institutions, so that it can ensure proper planning and interinstitutional coordination. This will help the Social Cabinet to establish itself as the leading entity in poverty reduction policy and in coordinating implementation of the PRS.
- 1.31 The Social Cabinet will have the following functions with respect to the PRS: (i) coordinating actions with the various government institutions involved in PRS execution; (ii) establishing the eligibility of PRS programs and projects; and (iii) ensuring that the PRS objectives are met.
- 1.32 While the makeup of the Social Cabinet seems to be sufficiently flexible for coping with its new function, more specific support will be required in the area of poverty reduction. It is not considered necessary to amend the Decree creating the Social Cabinet, but the institutions supporting it need to be strengthened. In accordance with the Decree, the Technical Support Unit of the Secretariat of State in the Office of the President (SDP) is to provide technical advisory services to the Social Cabinet. The SDP needs to be strengthened in order to fulfill these expanded support and advisory functions in the context of a comprehensive poverty reduction strategy. While the SDP has subsidiary bodies such as the Technical Support Unit (UNAT) and the National Management Evaluation System (SINEG), there are still institutional and technical weaknesses impeding implementation of the PRS. These relate to: (i) the need to reform the institutional organization of the UNAT for implementing what is essentially a multisectoral action plan; (ii) the lack of any official mechanism for interinstitutional consultation for strengthening PRS coordination; (iii) social sector entities face serious constraints in terms of computerization, and a lack of the reliable data and specialized analytical capacity needed to make timely use of poverty indicators in taking policy and budgetary decisions; and (iv) the lack of suitable mechanisms for publicizing investments and results achieved under the PRS.

¹⁰ The Social Cabinet is composed of the Ministers for Education, Health, Labor and Social Security, Agriculture and Livestock, and Culture, Arts and Sports, as well as the Lead Minister of the FHIS, the Executive Director of the National Agrarian Institute and the Technical Secretary for International Cooperation, and is coordinated by the Minister of the Presidency.

- 1.33 **The technical framework.** As the technical secretariat of the Social Cabinet, it was the UNAT that drew up the PRS and that will be responsible for monitoring its implementation. This institution has the powers needed for effectively coordinating the PRS executing ministries. However, the UNAT has neither a comprehensive framework for monitoring the agreed indicators nor the level of intersectoral analysis needed for taking decisions as required by the new horizontal focus of the PRS. To fill these gaps, it is essential to integrate the institutional structures and databases of the sectoral agencies (education and health) and the National Statistics Institute (INE). There is also insufficient information available for monitoring progress under existing poverty reduction programs.
- 1.34 Honduras currently has three computerized information systems in place: (i) the Programs and Projects Bank belonging to the SEFIN, which monitors physical progress for programs financed with reimbursable funds; (ii) the National System for International Technical Cooperation (SINACON), located within the Technical Secretariat for International Cooperation (SETCO) which records nonreimbursable assistance; and (iii) the Integrated Financial Information System (SIIF), administered by the SEFIN, which allows for financial monitoring of reimbursable and nonreimbursable programs. The information generated by the three systems covers only a portion of the PRS requirements and is highly fragmented, and therefore inadequate for decision-making.
- 1.35 **Budgetary management.** Despite the great strides that the Government of Honduras has made during the last three years in modernizing the public financial administration system, the current budgetary system has shortcomings as a tool for controlling the allocation and monitoring of public expenditure. Although the national budget is prepared on a program-budget basis, use of this technique is limited, and reflects only the organizational structure of the central government. Because there is no proper application of expenditure classification by program, it is impossible to identify clearly the outputs that each program is supposed to provide, in terms of goods and services, or the real and financial inputs used to produce them.
- 1.36 The SEFIN introduced a special financing source code in the 2001 budget as a mechanism for identifying programs and projects financed from the Poverty Reduction Fund (FRP) (see Component II, paragraph 2.28). This measure is not in itself a solution, however, since it can only be used for monitoring programs financed by the FRP, and does not cover the totality of PRS programs and projects. The ability to monitor all PRS programs is a key element in ensuring the accountability of expenditure under the HIPC Debt Relief initiative.
- 1.37 One weakness of the budgetary system is its use of an expenditure line called "global allocations" and a category called "centralized services". Neither concept is given a breakdown by expenditure object during the formulation phase or, on occasion, during the execution phase. This constitutes a source of distortion for the

budgetary expenditure classification system, and an obstacle in achieving transparency in the allocation of resources.

- 1.38 A major portion of programs and projects included in the PRS is to be executed by decentralized and deconcentrated institutions. The funding allocated to these institutions is included in the budget of the titular agency, under the global allocations item or, in the best case, under current and capital transfers. Subsequently, institutions draw up their operating and budget plan, which includes a breakdown of those transfers by expenditure object for examination and approval by SEFIN. This approval comes only after the fiscal year has commenced, which makes it impossible to use these budgets as a planning, programming and monitoring tool for programs and projects.
- 1.39 In order to monitor PRS execution and administer FRP resources in a comprehensive manner, institutional and operational arrangements are needed so that SEFIN can establish expeditious procedures to guarantee the rational allocation of resources, provide a flow of FRP funds consistent with the level of program execution, and achieve maximum returns from investments without compromising transparency and accountability.
- 1.40 **Accountability and participation.** To ensure the long-term sustainability of the PRS, the Government of Honduras undertook a series of consultations with the public and with the donor community in the course of formulating the PRS. The Bank supported this process with technical cooperation funded under the Central American partnership agreement with the Swedish International Development Agency (SIDA).
- 1.41 The Government of Honduras will have to ensure that civil society is involved in implementing the PRS, as it was in formulating it. To date there is no means of channeling citizen participation in a permanent and systematic manner that would ensure standing consultation and accountability. Until such time as there is a consolidated organic and institutional structure that will allow the public and the donor community to monitor this process, the continuity of the PRS will be at risk.
- 1.42 The PRS operating framework describes the need to create an Advisory Council on Poverty Reduction for the Social Cabinet. This would consist of representatives of the government and of civil society, and two representatives of the international financial community as observers.

E. Bank strategy

- 1.43 The Bank's strategy¹¹ for Honduras is focused on supporting basic social investment programs, while fostering a better approach to targeting limited concessional

¹¹ Honduras. Country paper. IDB, Regional Operations Department II. October 1999.

funding at the neediest segments of the population. It also recognizes the need to improve the quality of human resources through sound investments in education and health.

- 1.44 This program is consistent with the mandate from the Eighth Replenishment in terms of giving priority to the social sector and to loans that will support policy reforms in that sector. It is also consistent with the mandate to focus on reforms in the public sector, including budgetary and expenditure policies.
- 1.45 The Bank's strategy is being implemented through a series of programs aimed at reducing poverty. As noted earlier, implementation of the PRS is based on execution of existing programs and new ones financed through debt relief. Bank loans already in execution that are targeted at poverty reduction include: Family Allowances Program (1026/SF-HO); Social Investment Fund (1028/SF-HO); Basic and Middle Education Programs (1000/SF-HO); and Basic Services and Health Sector (1005/SF-HO). These operations are supplemented by others recently approved by the Board of Executive Directors, including: Revitalization of the Rural Economy (1063/OC-HO); Program to Fight Urban Poverty (1066/SF-HO); Poverty Reduction and Local Development (1068/SF-HO); and National Education Reform Program (1069/SF-HO). These projects taken together represent an integrated approach to reducing and alleviating poverty.
- 1.46 In 1996 the Bank approved a sector operation (967/SF-HO) in support of a public sector reform program. That operation included measures to increase the proportion of overall budgets devoted to basic services within the Ministries of Education and Health. A parallel technical cooperation program (968/SF-HO) helped to reorganize the institutional structure of both ministries in order to enhance their efficiency. The sector operation and the accompanying technical cooperation were intended to help launch an extended process of reform in the area of education and health, and were designed so the process could continue with subsequent operations.
- 1.47 Consistent with the strategy described above, the Bank in 1997 and 1998 approved loans 1000/SF-HO and 1005/SF-HO dealing with education and health reform.
- 1.48 Subsequently, in 1999 Honduras executed a further sector loan, the "Transition and Social Protection Program" (1041/SF-HO), for US\$30 million. The first tranche, of US\$20 million, was disbursed on December 20 of that year and the second, of US\$10 million, on December 20, 2000. The country successfully met the conditions precedent to both disbursements. Loan 1041/SF-HO supported creation of the Social Cabinet, which is today responsible for coordinating the PRS, and strengthened the social policy formulation capacity of its technical arm, the Technical Support Unit (UNAT). These two institutions are expected to take a leading role in coordinating and monitoring the PRS. The program also helped SEFIN to provide monitoring and technical assistance for priority programs so as to

ensure the continuity of reforms in health and education, and the goals established were successfully achieved.

- 1.49 Sector loan 967/SF-HO was intended to reorient social spending towards the primary level, and to reorganize the structure of the Ministries in order to achieve greater efficiency. Sector loan 1041/SF-HO was prepared at a time of emergency, and focused on protecting social expenditure. Investment programs have to date focused solely on implementing social policies covering certain specific aspects. This sector program was intended to establish conditions for transparent management of debt relief resources, with an emphasis on interinstitutional coordination and on organized participation by civil society in implementing social policies. By helping to consolidate the public finances, it has also served to maintain the pace of execution of those policies. These actions will assist Honduras in reaching the debt relief completion point.

II. THE PROGRAM

A. Objective

- 2.1 The general objective of the program is to help achieve a sustained reduction in poverty over the medium term. To do so will require effective implementation of the Poverty Reduction Strategy (PRS), which in turn will activate Honduras's eligibility for the Highly Indebted Poor Countries initiative (HIPC). Effective implementation of the PRS will require institutional changes as well as a new approach to formulating poverty reduction policies. The specific objective of the program is to bring about these changes by: (i) creating an institutional framework that will provide a transparent and inter-institutional focus for taking decisions about resource allocation; (ii) creating mechanisms for monitoring implementation of the PRS; (iii) creating the financial instruments needed for channeling and monitoring the funds provided through debt relief; (iv) developing systems for involving civil society in PRS implementation; and (v) fostering conditions for establishing a macroeconomic framework that will protect spending on poverty reduction programs.

B. Scope of the program

- 2.2 The program will help Honduras to bring about a qualitative change in the way social and economic policies are formulated, by targeting them on poverty reduction in a manner consistent with the PRS. By the end of this program, the country will have an operational framework (institutional and instrumental) for implementing the PRS. This new operational framework implies the use of modern approaches to public administration, and a transparent handling of domestic and external public funds, changes that are without precedent in Honduras. In particular, this new approach to public administration encourages participatory decision-making processes, systems for the physical and financial monitoring of all PRS programs, and social communication mechanisms based on coordinating the efforts of civil society and all the institutions committed to implementing the PRS.
- 2.3 One major achievement upon completion of this program will be the changes made to the structure of the general national budget, which will allow for detailed monitoring of the use of resources under all projects that make up the PRS. The system is expected to record not only the flow of funds but also the degree to which the programs' quantitative goals have been met. This will allow for more efficient budgetary allocation as a function of performance goals, and better program monitoring.
- 2.4 Finally, the program will help Honduras achieve greater macroeconomic stability by providing external funding, and this will assist the country in meeting the HIPC completion point, thereby ensuring that the PRS can be implemented.

C. Description

- 2.5 The program employs a sector approach in support of a set of concrete measures and policy decisions focused on facilitating institutional changes that will lead to greater inter-institutional coordination, the development of instruments for physical and financial monitoring of all PRS programs, participation by civil society, and consolidating the progress that has already been achieved in transforming the social sector. The program is based on a policy letter (Annex II) that sets out the overall guidelines and objectives. The specific conditions are incorporated in the policy matrix (Annex I), and will be reflected in the loan contract. The conditions relating to the first tranche are to be fulfilled before the first disbursement. The means of verifying compliance with each condition are set forth in Annex III.
- 2.6 It should be noted that the analysis of the problems as well as the specifics of the corrective measures shown in the policy matrix have been developed jointly with the entities responsible for compliance and with the Program Coordination Unit which will coordinate their implementation. In all cases, compliance with each condition has been confirmed to be feasible within the stipulated time limits, and the resources necessary for their execution have been confirmed to be available.
- 2.7 **Economic program.** Honduras is in the final stages of negotiations with the IMF on an economic program for the period 2001-2002, under the Poverty Reduction and Growth Facility (PRGF). This program seeks to stabilize the economy and maintain growth, while speeding up efforts to reduce poverty in the context of the HIPC initiative. The year 2001 is expected to see economic growth at 3.5% and an inflation rate of 10%, which will decline to 8% in 2002.
- 2.8 The program is based on a prudent fiscal policy as reflected in the central government's financial accounts, the results of which will incorporate improvements in tax administration and containment of expenditure in the non-social sectors. As well, wage and salary expenditures of the central government will be restricted. The deficit will be financed entirely from concessional external resources.
- 2.9 Monetary policy will support the inflation objective by managing liquidity in the banking system, to which end the Central Bank of Honduras will use its monetary absorption instruments. These actions will be accompanied by steps to strengthen the financial system and reinforce banking supervision.
- 2.10 In the external sector, the current exchange system will be adapted to ensure that the exchange rate is consistent with overall policy objectives to improve the competitiveness of the Honduran economy. External debt management will continue to be oriented towards obtaining concessional resources.

- 2.11 The actions described above will be accompanied by structural reforms to enhance the economic role of the private sector; to increase transparency and combat corruption; to support reforms now underway in the justice system and in the improvement of statistics.
- 2.12 **Description of the components.** The program is organized in three components that will include the conditions necessary to ensure: (i) creation of an institutional and instrumental framework for successful execution of the PRS; (ii) creation of financial instruments for the PRS; and (iii) creation of a broad forum for citizen participation to ensure consultation and accountability.

1. Component I. Creating an institutional and instrumental framework for implementing the PRS

- 2.13 The first component will support the creation and introduction of a modern institutional framework that will facilitate intersectoral coordination among PRS executing agencies responsible for the implementation of social policies. It also calls for developing the means of monitoring PRS indicators and assessing physical and financial progress with PRS programs. This new institutional scheme, based on a comprehensive, participatory approach to planning and monitoring PRS programs, will help to improve the targeting of fiscal resources at the poorest sectors. This component relates to two aspects: an institutional aspect, i.e. technical support to the Social Cabinet, and an instrumental aspect, i.e. monitoring PRS indicators and programs.

(i) Subcomponent 1.a: technical support to the Social Cabinet

- 2.14 **Objective:** The objective of this subcomponent is to support the Social Cabinet by creating an institutional framework that will provide it with the necessary technical support for taking decisions. The technical agency will have a multisectoral composition in order to cope with the horizontal nature of the Social Cabinet's functions. This institutional base will also make it possible to organize the establishment of priorities for the use of resources based on consultation between the Social Cabinet and civil society, and to create the means to publicize the use of PRS resources.
- 2.15 **Lines of action:** Existing institutions will be used in order to obviate the creation of new institutions and to avoid increases in operating costs. A PRS Analysis Team (EDA) will be established under the SDP and within the UNAT to advise the Social Cabinet on the annual programming of PRS projects. This subcomponent will ensure that operational rules for the EDA are set and that its needs in terms of technical capacities are identified.
- 2.16 The Analysis Team will prepare an annual proposal for prioritizing PRS programs through: a programming and priority-setting exercise for PRS programs and

projects, targeting investments, and preparing and releasing progress reports. Other functions of the EDA will include assisting with the definition and monitoring of poverty indicators; preparing and publishing progress reports on the PRS and proposing any necessary corrective measures; providing operational assistance to the Ministries in executing the PRS, in working with geographic and demographic targeting mechanisms, and in interinstitutional coordination. In keeping with the multisectoral nature of its responsibilities, programming and priority setting will be done jointly between UNAT and various Ministries and programs that make up the PRS, to which end formal channels of communication will have to be established. Participation by the Ministries and the decentralized institutions of government will ensure the needed articulation between public and municipal demands and PRS eligibility criteria. These institutions will identify programs eligible for financing with resources earmarked for PRS programs within the respective thematic areas. Multisectoral coordination will ensure a more comprehensive focus and will reduce fragmentation in the allocation of resources.

- 2.17 The process for selecting and prioritizing PRS projects will originate with the EDA, which will examine priorities jointly with the SEFIN, the Ministries and the PRS program executing agencies. The role of SEFIN at this stage will be to reconcile available FRP funds with the demand for financing. Based on this analysis, the SDP will submit a proposed list of priority programs and projects to the Social Cabinet and to the Advisory Council (see Component III, paragraph 2.39). Those bodies will establish priorities and guidelines for the PRS and transmit them to the Minister for Finance. On the basis of these priorities, SEFIN will formulate budgetary guidelines. With these budgetary guidelines, the Ministries will prepare the sector budgets for final consolidation by the SEFIN. Progress reports from the Ministries will be submitted to the UNAT which will examine them and use them to make any necessary adjustments to planning for the following year.
- 2.18 One of the eligibility criteria for programs and projects to be financed under the PRS will relate to the environment. Support will be provided to programs for reducing poverty or enhancing living standards for the poor only if they are feasible from an environmental viewpoint and if their indicators and monitoring systems include environmental variables.
- 2.19 To ensure the transparency of the government's PRS efforts, active communication will be maintained the civil society through mechanisms for publicizing government activities at various levels (central, municipal and community). The Social Cabinet and the Advisory Council will specify the kinds of information to be published, the frequency of publication, and the channels to be used at each level, and the SDP will be responsible for overseeing public dissemination.
- 2.20 Disbursement of the **first tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following conditions:

- a. Institutional mechanisms must have been designed, including creation of an interinstitutional technical team, for programming and prioritizing PRS programs and projects in such a way as to ensure coordination among the various institutions involved in implementing the PRS.
 - b. The SDP must have established a PRS analysis team (EDA) with the analytical and information-processing capacities to provide technical support to the Social Cabinet, with, as a minimum, the functions described in paragraph 2.16 of the document.
 - c. A system must have been designed for publicizing information at the central and municipal levels on the allocation of PRS resources, the performance of PRS indicators, and the progress achieved under its programs and projects.
- 2.21 Disbursement of the **second tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following conditions:
- a. The interinstitutional technical team must have been established and the operations manual for giving effect to the institutional mechanisms proposed in the design must have been approved.
 - b. PRS programs and projects must have been programmed and prioritized, on the basis of the coordination mechanisms developed under the first tranche.
 - c. The PRS Analysis Team must be operating within the SDP.
 - d. The public dissemination system must be in operation.

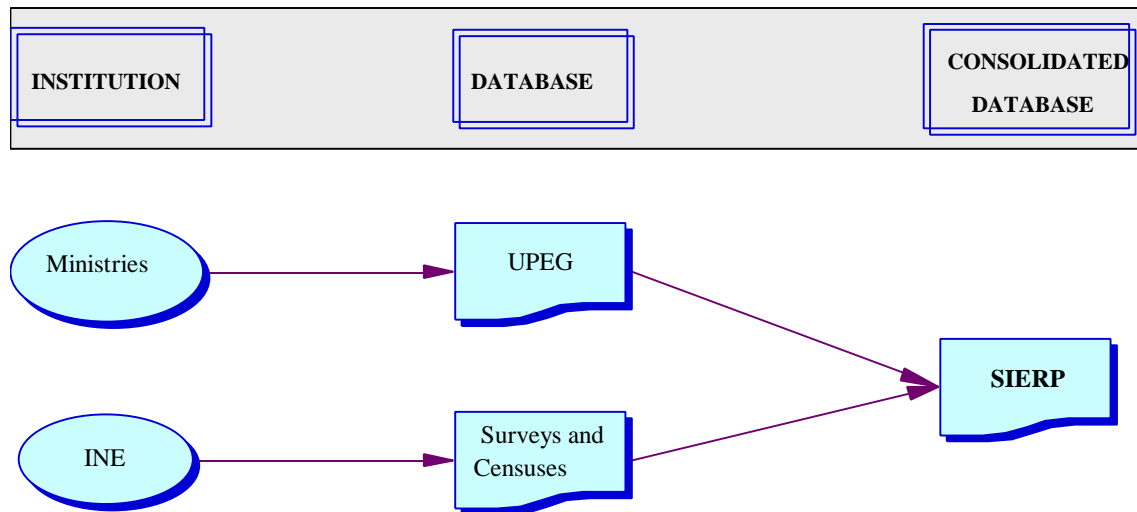
(ii) Subcomponent 1.b. Monitoring PRS indicators and programs

- 2.22 **Objective:** The Government of Honduras has committed itself, in the PRS paper, to meet specific indicators and goals by the year 2015.¹² The objective of this subcomponent is to design and implement an instrumental scheme for monitoring the indicators agreed in the context of the PRS. This instrumental scheme will make it possible to assess progress in implementing poverty reduction policies, against the goals established in the strategy, and to monitor physical progress with PRS programs and projects. The SDP will establish an organizational structure such that these monitoring systems will provide feedback to the system for prioritizing the programs already described, and thus enhancing the formulation of social policies.
- 2.23 **Lines of action:** The Government of Honduras will develop two parallel monitoring systems: (i) the PRS Indicators Monitoring System (SIERP), and (ii) the

¹² These include substantive progress in the advancement of Honduran women, in living standards for the general public, in human capital formation (protecting education, health and nutrition), in access to drinking water and basic sanitation, and in environmental sustainability.

- system for monitoring physical and financial progress under PRS programs and projects, using the SEFIN database.
- 2.24 **SIERP.** A technical team for monitoring PRS indicators will be set up within the SDP. The functions of this team will be to coordinate and carry out the work of monitoring and analyzing the indicators established in the PRS and publishing periodic progress reports on the implementation of poverty reduction policies.
- 2.25 The first step will involve preparation of a systematic mechanism for monitoring PRS indicators, submitting it to stakeholders, and achieving national and international consensus on the proposed system. This design will serve as the basis for preparing the implementation phase of SIERP, within a broader program of support for the PRS. The SIERP design phase will be supported by TC-01-01-05-05, financed from the Japanese Special Fund.
- 2.26 The final design of the SIERP, as agreed with the sector bodies and civil society and approved by the government, must provide for at least four segments: (i) the institutional scheme for the work of monitoring the indicators; (ii) a plan for monitoring the indicators; (iii) a plan for ensuring coordination between the sector bodies and the donor community; and (iv) consultation and dissemination mechanisms. The design of the first two segments must contain: the budget, the terms of reference and a description of the positions on the analysis team, including the specific analytical function of the SIERP, the implementation plan for the SIERP together with the first year's work program, the interinstitutional coordination mechanisms, the members of the team reporting to the SIERP within the various SDP offices, and the liaison counterparts in the sectoral agencies, and the INE, and the training plan for implementing the SIERP. The design of the third segment, the plan for coordinating international cooperation, must contain: the design of a registry of projects relating to each of the PRS indicators and of a mechanisms for maintaining a permanent and up-to-date flow of information as agreed with international partners, and a work plan for implementing this registry. The design of the fourth segment, mechanisms for disseminating and accessing the monitoring results, must be negotiated with the sector bodies, civil society and the donor community. Finally, thought must be given to the institutional and financial provisions for maintaining each of the SIERP components.
- 2.27 The subsystems that will feed into the **SIERP** (figure 2.1) are tentatively scheduled to include:
- a. UPEG, Ministerial Management Planning and Evaluation Units, with the registry of surveys and sector censuses and sectoral evaluations.
 - b. Censuses and surveys, compiled by the National Statistics Institute (INE), which is to be used for monitoring poverty indicators.

Figure 2.1: Makeup of the consolidated SIERP database

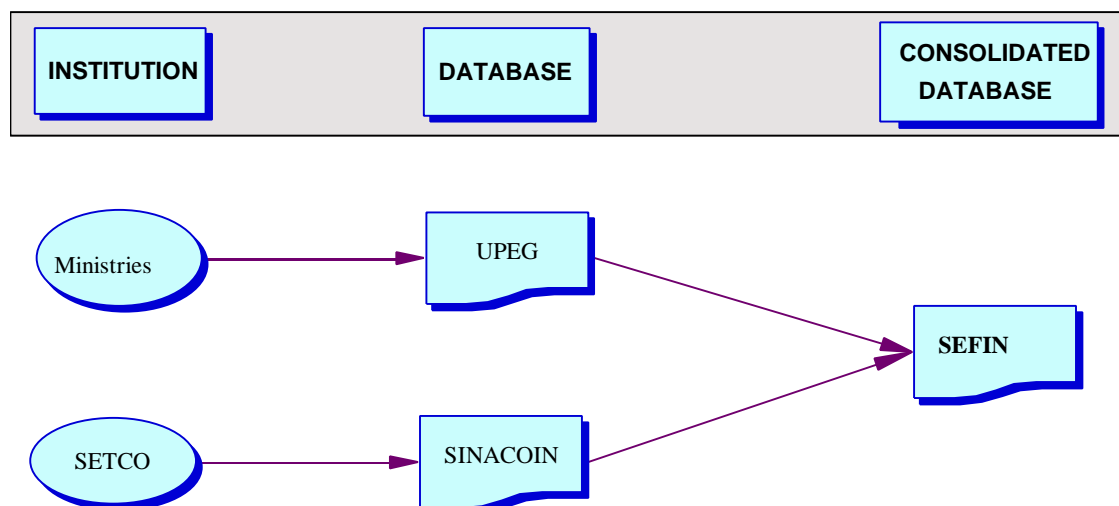


2.28 **The SEFIN database.** This will contain physical and financial information on PRS programs. SEFIN has available the Integrated Bank of Programs and Projects under the Public Investment System (BIP-SISPU) which contains the origin of funds, a brief description of programs, their physical and financial goals, and monitoring of the project cycle. The data input for the BIP-SISPU will be provided by the UPEG. As well, SEFIN has the Integrated Financial Information System (SIIF) which will provide the flow of financial information. Work is underway to provide connectivity between these two systems so as to ensure data compatibility. This information will be used to prepare pre-established spreadsheets and tables on the progress achieved under PRS programs and projects, which will be sent to the SDP for analysis, preparation of reports, and release of information. SEFIN will set up a monitoring team that will be responsible for generating and maintaining a consolidated database for monitoring PRS programs and projects.

2.29 The subsystems that will feed into the **SEFIN database** (figure 2.2) will be:

- a. The UPEG, the Management Planning and Evaluation Units, located within the Ministries, which will record physical and financial progress with PRS programs and projects underway.
- b. The SINACOIN, National System for International Cooperation, located within the Technical Secretariat for International Cooperation (SETCO), which will record information on external financing with nonreimbursable funds.

Figure 2.2: Formation of the consolidated BIP-SISPU database



2.30 There are plans for combining the SIERP and the SEFIN database into a single database. The benefit of such a united database is that it would ensure the compatibility of information derived from different systems, and allow it to be captured automatically.

2.31 The current status of the databases is shown in Table 2.1.

Table 2.1: Current status of databases

Institution	Database	Current status
Ministries	UPEG	The databases of the Ministries are receiving support in the form of equipment and training financed by loan 906/SF-HO
INE	Surveys/census	Statistical work is underway. The population census is planned for September 2001. Program HO-0206, 2001 Census Support
SETCO	SINACOIN	SETCO has hired a consultant to begin the design of the SINACOIN. He is working to make the database compatible with BIP-SISPU
SDP	SIERP	The Japanese Fund has approved technical cooperation for the design of the system. TC-01-01-05-05
SEFIN/SISPU	BIP-SISPU	This database is creating systems for communicating with the UPEG. A pilot transmission is planned in July 2001. The software is to be installed in all the UPEG during September. Training for the UPEG will begin in October. A pilot test of the network's functioning will be conducted in November. Input to the database will begin in January 2002. Loan 906/SF-HO

2.32 Following are the conditions for the disbursement of the **first tranche**:

- a. The technical counterpart of the SDP must have been designated and consultants identified to work with this team to develop the PRS Indicators Monitoring System (SIERP).
- b. Consulting services must have been contracted to develop the Integrated Bank of Projects for the Public Sector Investment System (BIP-SISPU) for monitoring PRS programs and projects throughout the project cycle.
- c. Interinstitutional agreements must have been signed to provide the information needed to create the following consolidated databases: (i) the PRS Indicators Monitoring System (SIERP); and (ii) the SEFIN databases for physical and financial monitoring and for monitoring the PRS programs' project cycle.

2.33 Following are the conditions for disbursement of the **second tranche**:

- a. The final design of the SIERP must have been submitted, as agreed with the PRS Advisory Council and approved by the Social Cabinet, containing institutional arrangements, technical bases, mechanisms for coordination with other donors, as well as mechanisms for consultation and dissemination of the reports produced, as described in paragraph 2.26.
- b. A PRS indicators monitoring plan must have been submitted, approved by the Social Cabinet and containing: (i) an evaluation of the methodology for collecting information and validating its quality; and (ii) a monitoring schedule.
- c. The final design of the BIP-SISPU system must have been submitted, and must have been shown to be functional by means of a pilot experiment.
- d. Reports must have been submitted to the Social Cabinet on: (i) the status of PRS indicators during the second half of 2001; and (ii) monitoring of physical and financial progress under the PRS programs, based on the information produced by the SEFIN.

2. Component II. Financial instruments for the PRS

- 2.34 The government will establish financial and budgetary mechanisms to ensure transparency in raising, allocating and executing the resources earmarked for the PRS. The government will establish a financial facility, to be called the Poverty Reduction Fund (*Fondo para la Reducción de la Pobreza*, FRP) to channel all domestic and external funding in support of the PRS. SEFIN will introduce structural and classification changes to the General National Budget so as to identify all PRS projects and programs and to distinguish those programs that will be financed with funds resulting from debt relief. This will allow for proper budgetary and financial monitoring of the PRS. The government will thereby

ensure that the programs and projects financed are consistent with its social policy and will contribute to poverty reduction, within the context of macroeconomic stability. This component has been designed in consultation with the International Monetary Fund and the World Bank. The design of the FRP is described under the first subcomponent, "The Poverty Reduction Fund", and its budgetary aspects are described in the second component, "Budgetary Management".

(i) Subcomponent 2.a: The Poverty Reduction Fund

- 2.35 **Objective:** The objective is to create a financial facility that would remain in operation for about 15 years. The FRP will ensure transparency in raising, channeling and allocating the funds to be used in the PRS programs and projects. PRS funds will be derived from: (i) forgiveness of external debt service payments, under the HIPC initiative; (ii) proceeds to the central government from the sale, concession or other form of transfer of public assets to the private sector; and (iii) funds that the country may obtain from other, non-creditor countries or agencies for combating poverty, where it has been agreed to channel these funds through the PRS. PRS resources will be used to finance: (i) PRS measures, programs and projects declared eligible by the Social Cabinet, consistent with the annual ceiling determined by SEFIN; (ii) project inspection; (iii) systems for monitoring PRS indicators and the physical and financial progress of PRS programs; and (iv) the Central Bank's commission from the investment of liquid resources.
- 2.36 **Lines of action:** The FRP was created by legislative decree with the following characteristics: (i) the Social Cabinet is to establish priorities and the eligibility of programs to be financed by the FRP, and will oversee compliance with objectives of the strategy, together with the Advisory Council; and (ii) SEFIN will be responsible for its administration, and will determine the annual amount to be earmarked for financing the PRS, prepare a multiyear PRS programming cycle; evaluate the PRS projects and prepare an annual disbursement program for the PRS and the FRP.
- 2.37 Proper management of FRP resources will require: (i) consolidating funds in Central Bank accounts; (ii) allowing the Ministries and autonomous institutions to execute poverty reduction programs, thereby avoiding the creation of new institutions and the attendant higher operating costs; (iii) disaggregating budgetary appropriations for all programs and projects aimed at reducing poverty; and (iv) exerting internal and external control over all expenditures.
- 2.38 The design of the FRP will address organizational aspects, technical/financial budgetary aspects, the legislative decree creating the FRP, and its regulations. The executive decree creating the FRP must contain, as a minimum: objectives, duration, characteristics, funding sources, instructions for the use of funds and for their investment. It will also establish organizational arrangements for the

administration, monitoring and auditing of the Fund, and will define the participating bodies and their respective functions, including those relating to the role of the Advisory Council.

- 2.39 The regulations must contain, as a minimum: (i) procedures for presenting and selecting programs and projects to be financed with FRP resources; (ii) a description of the functions of the SEFIN units that will be responsible for administering FRP resources; (iii) provisions governing the scope, frequency, selection and contracting of audits to be conducted on FRP resources; (iv) the scope, frequency and manner of publishing reports on the use of FRP resources; and (v) the manner for determining the use of FRP resources to finance the inspection of programs and projects financed with FRP resources and to finance the monitoring and evaluation of the PRS indicators, physical and financial progress under the PRS, and budgetary monitoring of the PRS.
- 2.40 Disbursement of the **first tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following condition:
- a. A draft decree creating the Poverty Reduction Fund must have been submitted to the National Congress. This must contain at least the provisions stipulated in paragraph 2.38.
- 2.41 Disbursement of the **second tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following conditions:
- a. The decree creating the Poverty Reduction Fund (FRP) must be in force.
- b. The FRP Regulations containing at least the item stipulated in paragraph 2.39 must be in force.

(ii) Subcomponent 2.b. Budgetary management

- 2.42 **Objective:** The objective of this subcomponent is to strengthen the budget as a tool for controlling and monitoring PRS resources. In addition, it will ensure transparency by establishing procedures and controls to facilitate monitoring of the origin and destination of PRS resources, without impeding program execution.
- 2.43 **Lines of action:** Amendments to the General National Budget will allow for the allocation, execution and monitoring of PRS resources. To this end, SEFIN will make the needed changes in budgetary management so that PRS programs can be monitored, by program and by source of financing. This will make it possible both to generate the required information on progress with PRS project execution and to control the use of funds earmarked for the FRP. Technical cooperation has been provided in support of efforts to strengthen SEFIN's budgetary management.

2.44 Disbursement of the **first tranche** will be conditional upon compliance, to the Bank's satisfaction, with the following conditions:

- a. The Draft General National Budget for the year 2002 must identify PRS resources, ensure transparent monitoring of the source and application of funds through the establishment of budgetary allocations within specific programming structures, thereby eliminating the use of global allocations, including those for centralized services.
- b. The general provisions of the Draft General National Budget for 2002 must contain a rule requiring approval of budgets for the year 2002 for the decentralized and deconcentrated entities that are executing or will execute programs and projects included in the PRS, prior to the transfer of resources for financing those programs and projects.
- c. The process of regularizing approval of the budgets of deconcentrated and decentralized entities executing PRS programs must have been initiated, and SEFIN approval must have been obtained for the draft budgets for 2001, at least.
- d. The Social Cabinet must have approved and published eligibility guidelines for PRS programs and projects.

2.45 Disbursement of the **second tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following conditions:

- a. The General National Budget for the year 2002, or for the year of disbursement, must have been approved by the National Congress under the terms stipulated for the first tranche.
- b. The General Provisions governing the General National Budget for the year 2002 or for the year of disbursement must contain a rule requiring approval of budgets for the year 2002 or for the year in which the deconcentrated and decentralized institutions execute or would execute programs and projects included in the PRS, before transferring funds to finance those programs and projects.
- c. The budgets of the deconcentrated and decentralized institutions executing PRS programs for the year 2002 or for the year of disbursement must identify PRS resources, guarantee transparent monitoring of the source and application of those resources, by establishing budgetary allocations within specific programming structures, and eliminating the use of global allocations, including those for centralized services.
- d. Budgets for the current fiscal year or for the year of disbursement must have been approved for the deconcentrated and decentralized entities executing PRS programs, before PRS funds are transferred to those institutions.

- e. Semi-annual physical and financial progress reports on PRS execution must have been published, so that expenditures can be monitored by program and by source of funding.

3. Component III. Institutionalizing citizen participation

- 2.46 **Objective:** This component seeks to institutionalize participation by nongovernmental agents in implementing the PRS, through creation of an Advisory Council. This body will act as a liaison mechanism between the Government of Honduras and civil society and will serve as a means for consultation and for monitoring PRS implementation. It will consist of representatives of government and civil society, as well as the donor community (as observers). Ensuring representation of civil society in this way will help to strengthen the growing process of democratic participation in the country, will encourage consensus on project priorities and, most important of all, will contribute to the sustainability of the PRS.
- 2.47 **Lines of action:** The legislative decree creating the FRP will provide for creation of a PRS Advisory Council. This decree will stipulate at least the functions of the Council, the mechanisms for dissemination, coordination and articulation with other bodies at different levels and its membership. The Council will consist of equal numbers of representatives of the government and of civil society and. It will be chaired by the Social Cabinet Coordinator. It will also have as members the Ministers of the Presidency, Finance, and Interior and Justice. There will also be a representative of the Association of Municipalities of Honduras (AMHON), as well as three representatives of civil society. Mechanisms for selecting members of the Advisory Council, as well as its composition and functions, will be defined through a participatory process that will ensure that the interests of all stakeholders are represented. Two representatives of the international financial community, proposed by multilateral and bilateral agencies, will be invited to Council meetings as observers. Generally speaking, its function will be to advise the Social Cabinet on matters relating to the identification, eligibility and prioritization of programs and projects. It will also recommend steps relating to management of the PRS, monitoring, participation of civil society, and the publication of information. Members of the Advisory Council will perform their duties *ad honorem*; they will meet at least once every two months, or whenever convened by the coordinator, or as established in the Council's operating regulations.
- 2.48 The Regulations of the PRS Advisory Council must contain, as a minimum: (i) procedures for the election of its members; (ii) operating procedures of the Council, including the manner in which its executive is to function.
- 2.49 Disbursement of the **first tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following conditions:

- a. The Decree creating the FRP must contain provisions for creation of the PRS Advisory Council, stipulating at least: the functions of the Council, the mechanisms for dissemination, coordination and articulation with other bodies at different levels, and its membership, to consist of representatives of the government, of civil society and observers from the donor community.
- 2.50 Disbursement of the **second tranche** will be contingent upon compliance, to the Bank's satisfaction, with the following conditions:
- a. The Decree creating the PRS Advisory Council must be in force.
 - b. The Regulations for the PRS Advisory Council must be in force, and must contain as a minimum: (i) the procedure for appointing its members; and (ii) operating procedures for the Council, including the manner in which its executive will function.
 - c. The PRS Advisory Council must have begun operations.

D. Sources and conditions of Bank financing

- 2.51 The terms of the loan are detailed in Table 2.3.

Table 2.3: Loan conditions	
Source of financing	Fund for Special Operations (FSO)
Amount	US\$30 million
Amortization	Terms: 40 years
Grace period	10 years
Disbursement period	2.5 years
Interest rate	1% during the grace period and 2% thereafter
Supervision and Inspection	1% of the value of the loan
Credit fee	0.5% annually on the undisbursed balance, as of the date of approval by the Board of Executive Directors

III. PROGRAM EXECUTION

A. Borrower and executing agency

- 3.1 The borrower will be the Republic of Honduras. The Ministry of Finance (SEFIN) will be the executing agency for the sector program. SEFIN is the body responsible for managing the FRP, in accordance with guidelines established by the Social Cabinet, and together with UNAT is a key element in formulating government economic and social policies.

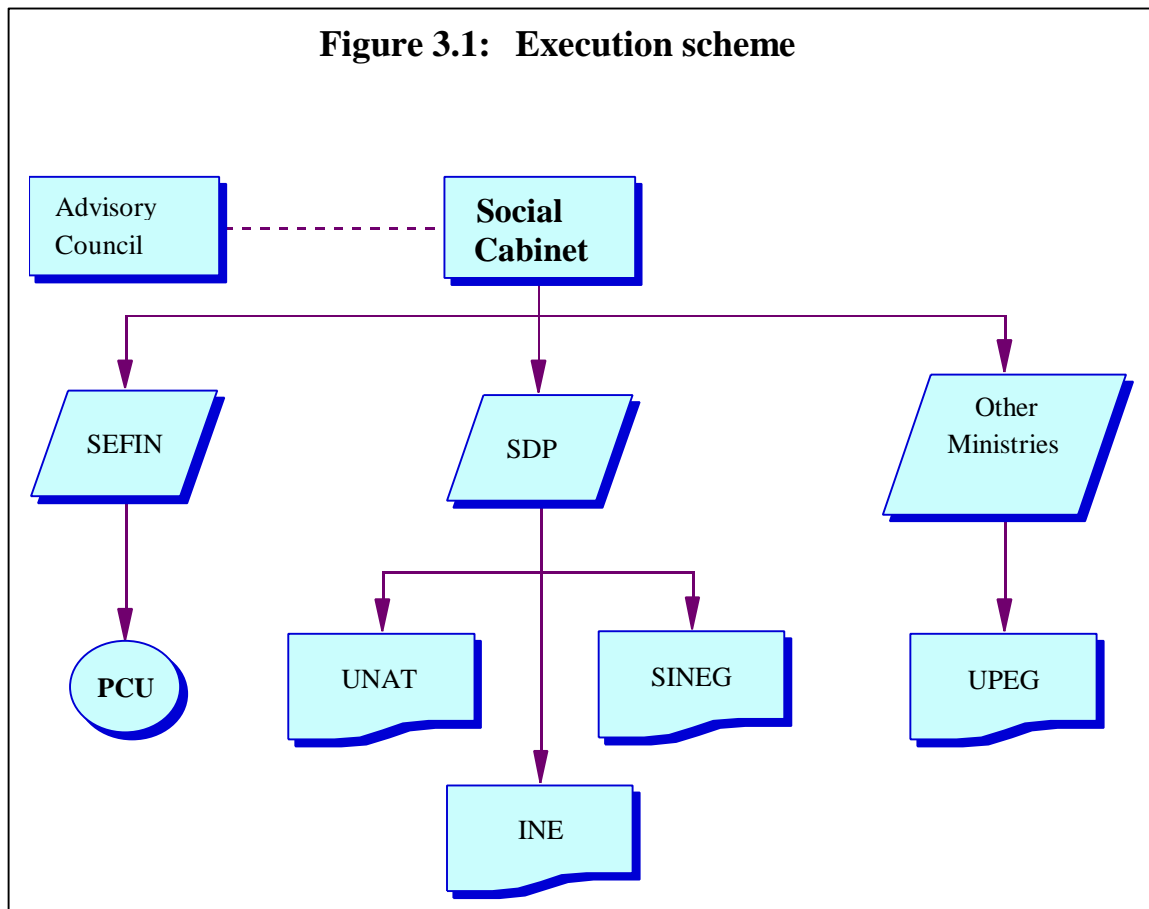
B. Program execution and administration¹³

- 3.2 SEFIN will be responsible for administering and monitoring the sector program. In this respect, it will oversee compliance with the conditions pertaining to the two tranches of this program. The executing agency will work closely with the SDP, given the latter body's important role in providing technical support to the Social Cabinet. It will also work with the ministries and autonomous or decentralized institutions responsible for PRS execution, in monitoring the execution of the programs. As well, it will be guided by the Social Cabinet with respect to regulations and other changes indicated in the policy matrix for the loan (Figure 3.1).
- 3.3 The executing agency (SEFIN) will establish a Program Coordination Unit (PCU) which will monitor fulfillment of the conditions of the sector program and will prepare quarterly progress reports, as well as a final report prior to each disbursement. The program will be accompanied by technical cooperation to support the functioning of the PCU. The PCU will consist of three consultants: the coordinator and one consultant will be funded from the Fund for Special Operations (FSO), while the third member will be covered by counterpart resources.
- 3.4 The PCU will be responsible for the following activities:
- a. Preparing quarterly progress reports for submission to the authorities and the Bank.
 - b. Holding periodic evaluation and discussion sessions with the PRS executing entities to take decisions as necessary for achieving program goals on time.
 - c. Cooperating with participating entities in measuring the degree of compliance with the conditions in the program's policy matrix.

¹³ This chapter is limited to execution of the sector loan. Execution and monitoring mechanisms for implementing the PRS are described in the three components of this document.

- d. Preparing all documentation and reports specified in the loan contract, and ensuring that all contractual obligations are met.
- e. Representing the Government of Honduras during administration missions conducted during program execution.
- f. Overseeing execution of the parallel nonreimbursable technical cooperation activities.

Figure 3.1: Execution scheme



C. Execution period and disbursement schedule

- 3.5 The maximum execution period of the program will be 24 months, and the disbursement period will be 30 months. The loan will be disbursed in two equal tranches of US\$15 million. The effort required to meet the loan conditions has been examined, and it is planned that conditions for the first tranche will be met prior to the first disbursement. It is expected that the conditions for the second tranche will be met within 12 months after the loan contract comes into force.

D. Disbursement procedures

- 3.6 Quick-disbursing funds will be used to finance the aggregate costs in foreign exchange, including eligible imports from member countries of the Bank. The simplified procedures for the disbursement of sector loans established in Document GN-2001-2 will be used. Disbursements will be made upon receipt of applications from the borrower, and upon confirmation that the agreed policy conditions have been met.
- 3.7 With respect to disbursement, the borrower undertakes: (i) to keep separate accounting records and supporting documentation to allow for external audits or verifications as requested by the Bank; and (ii) to maintain a separate bank account in which proceeds of the loan will be deposited.
- 3.8 As a condition precedent to each disbursement, the borrower will present evidence to the Bank's satisfaction that the macroeconomic setting is consistent with program objectives. The Bank may consult the International Monetary Fund in the course of reaching a decision.

E. Accounting and auditing

- 3.9 The borrower, through the executing agency, will be responsible for maintaining accounting and financial records on the use of proceeds from the loan and for preparing and submitting the disbursement request to the Bank, and guaranteeing that those documents are available for inspection by the Bank or by external auditors. The borrower will maintain the bank account referred to in paragraph 3.7 for the proceeds of the loan and will provide evidence to the Bank that such an account has been opened as a requirement for the first disbursement.

F. External audit

- 3.10 The Bank reserves the right to ask the borrower to submit financial reports on the use of funds from the loan, reviewed by independent auditors previously accepted by the Bank.

G. Program monitoring and evaluation

- 3.11 The borrower, through the Executing Agency, will provide the Bank within 30 days after the close of each calendar quarter and during program execution, a report on progress achieved in implementing the program. In addition, the borrower, through the Executing Agency, will meet with the Bank, at times and places to be agreed, to exchange opinions on progress achieved in implementing the program, based on the progress reports. If the Bank finds the status of program execution to be unsatisfactory after reviewing and discussing the reports submitted by the borrower, the borrower will, within 30 days after such notification, present reports or plans for adjusting program execution and scheduling.

H. Inspection and supervision

- 3.12 The Bank will establish the inspection procedures it considers necessary for satisfactory execution of the sector program. The borrower will cooperate fully and will provide all assistance and information necessary for these purposes.

I. Ex post evaluation

- 3.13 The Bank will conduct an evaluation of the program subsequent to execution, in order to determine the extent to which its objectives have been met. For these purposes, the borrower will cooperate with the Bank and will provide any information, data and documents that the latter may request. In addition, the borrower will give the Bank all necessary technical, logistical and administrative support in carrying out the ex post evaluation.

J. Policy letter

- 3.14 The Bank agrees with the borrower on the policies set forth in the policy letter attached as Annex II this document. In that letter, the government formulates general macroeconomic intentions and specific policy actions in areas relating to institutions, instruments and citizen participation.

K. Environmental and social aspects

- 3.15 The program will focus on transformations relating to institutions, instruments and participation and will require no measures that would have any direct impact on the environment. The social aspects of the operation are positive, since the program will: (i) bring about institutional change; (ii) create instruments; and (iii) facilitate stakeholder participation in the technical analysis, as well as involving civil society in consultation and monitoring of poverty reduction efforts.
- 3.16 This operation qualifies as a social equity enhancing (SEQ) project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704), because it is targeted essentially at supporting social sector reforms. The program in fact establishes explicit performance indicators for measuring poverty reduction and social equity enhancement.
- 3.17 Although the program is designed to increase efficiency in the application of poverty reduction policies, because it is a quick-disbursing sector operation it is not eligible for classification as a poverty targeted investment (PTI).
- 3.18 By consolidating the country's public finances, the program will help to maintain the pace of execution for projects aimed at reducing poverty. The program will therefore reinforce arrangements already established in other social projects with respect to gender aspects, poverty targeting, the role of the indigenous population and environmental protection.

IV. FEASIBILITY, BENEFITS AND RISKS

A. Feasibility

- 4.1 The Poverty Reduction Strategy enjoys the support of Honduran society, of all political parties, and of the donor community. The fact that there was broad participation in formulating the strategy gives it a solid foundation for future execution, even with the change of government that will take place at the end of the year.
- 4.2 Monitoring and control instruments are compatible with Bank requirements. SEFIN will have responsibility for coordinating and promoting the actions needed to meet the conditions included in the matrix. SEFIN will have the support of a project coordination unit, a technical group that was also involved in the operation's design. This means that there will be a local counterpart with the capacity to monitor program execution and ensure timely fulfillment of program goals.
- 4.3 In terms of the technical feasibility of the actions required to meet program conditionality, all conditions were specified in close cooperation with the entities responsible for fulfilling them, together with technical experts from SEFIN and from UNAT. The policy letter reflects the existing consensus on the feasibility of the proposed actions and the planned timetable for implementing them, as well as the government's commitment to those actions.
- 4.4 The project team and the Honduran counterpart have identified sources of financing for all the activities that will require technical support. In preparing the project, the government is being assisted through the following nonreimbursable technical cooperation activities:
 - a. **SEFIN.** Creation of the Project Coordination Unit for a limited time, with nonreimbursable FSO funding of US\$64,000 and US\$27,000 in counterpart funding. The agreement with the Government of Honduras has already been signed and consultants have been hired.
 - b. **SEFIN.** Creation of the Poverty Reduction Fund, changes in the General National Budget, and its regulations, with nonreimbursable FSO funding of US\$45,500. The agreement with the Government of Honduras has already been signed and the consultants have been hired.
 - c. **UNAT.** Design of the national system for monitoring poverty indicators, with funding from Japanese Technical Cooperation in the amount of US\$150,000, and US\$30,000 in domestic counterpart funding. The technical cooperation has already been approved by the Japanese Fund and the agreement is awaiting signature by the Representative and the Government of Honduras.

- d. **UNAT.** Creation of the Advisory Council and its regulations, and the draft legislation. Financed through technical cooperation under the IDB/SIDA partnership in the amount of US\$55,000. The agreement with the Government of Honduras has already been signed and the consultants have been hired.

B. Benefits

- 4.5 The program will help Honduras to bring about a qualitative change in the way social and economic policies are formulated, by targeting them on poverty reduction in a manner consistent with the PRS.
- 4.6 It will also promote use of a modern and innovative system of public administration, unprecedented in Honduras, in which the processes of decision-making, monitoring, evaluation and social communication will be based on coordinated efforts of civil society and all the institutions involved in implementing the PRS.
- 4.7 The program will contribute over the short term to economic stability, supporting the central government financially and allowing execution of PRS programs.
- 4.8 By stabilizing the country's public finances, PRS implementation will be facilitated and Honduras will be in a better position to undertake the human capital investment needed to achieve sustainable growth. In addition it will allow the use of interim debt relief and government contributions for reducing poverty, thereby helping Honduras to reach the completion point under the HIPC initiative.
- 4.9 The changes to be made in the General National Budget and the support for development of a computerized information system will make it possible to monitor PRS indicators, the flow of funds, and physical progress by program. This will improve the efficiency of resource allocation against performance targets.

C. Risks

- 4.10 Honduras is to hold presidential elections in November 2001, and it is possible that this program could encounter difficulties under a new government. The risk of noncompliance that this situation implies should be mitigated by the commitments that have been made to civil society and to the international agencies involved in preparation and execution of the PRS. Moreover, public consultations with the various political party candidates have shown that there is broad support for the PRS. As well, the PCU will provide follow-up to these activities.
- 4.11 The HIPC requires a comprehensive poverty reduction strategy that will be financed with proceeds from debt relief, from the capitalization or private-sector concessioning of public services and from concessional external resources. The fact that there will be a time lag in receipt of these resources, especially those deriving from debt relief, poses a risk to implementation of the PRS, and therefore to

Honduras's ability to meet the HIPC completion point. This operation will ensure continuity in the execution of the successful social programs that are now underway and that form an essential part of the PRS.

- 4.12 Current institutional and operational weaknesses pose a risk to successful implementation of the PRS. This program will encourage institutional reorganization that will allow involvement by civil society and those in charge of executing the PRS in identifying and selecting priority programs. The program will also help to develop the instruments for monitoring progress under the PRS, and will enhance the transparency and accountability of government actions.

Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction Strategy (HO-0185)

Policy Matrix

Objective	Conditions for the first tranche	Conditions for the second tranche
To maintain economic stability and growth so as to support execution of poverty reduction programs	To maintain a macroeconomic setting consistent with program objectives	To maintain a macroeconomic setting consistent with program objectives
COMPONENT 1: CREATING AN INSTITUTIONAL AND INSTRUMENTAL FRAMEWORK FOR IMPLEMENTING THE POVERTY REDUCTION STRATEGY		
Subcomponent 1.a: Technical Support to the Social Cabinet		
To support the Social Cabinet by creating an institutional framework that will provide it with the technical support needed for decision-making.	<p>Institutional mechanisms must have been designed, including creation of an interinstitutional technical team, for programming and prioritizing PRS programs and projects in such a way as to ensure coordination among the various institutions involved in implementing the PRS.</p> <p>The SDP must have established a PRS analysis team (EDA) with the analytical and information processing capacities to provide technical support to the Social Cabinet, with, as a minimum, the functions described in paragraph 2.16 of the loan proposal.</p>	<p>The interinstitutional technical team must be established and the operational institutional mechanisms must have been approved.</p> <p>Multisector planning must be established on the basis of the coordination of the first tranche.</p> <p>The PRS Analysis Team must be established in the SDP.</p>
	A system must have been designed for publicizing information at the central and municipal levels on the allocation of PRS resources, the performance of PRS indicators, and the progress achieved under its programs and projects.	The public dissemination of information must be established.

Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction Strategy (HO-0185) Policy Matrix		
Objective	Conditions for the first tranche	Conditions
Subcomponent 1.b: Monitoring PRS indicators and programs		
To design and implement an instrumental scheme for monitoring the indicators agreed in the context of the PRS and physical and financial progress with PRS programs and projects.	The technical counterpart of the SDP must have been designated and consultants identified to work with this team to develop the PRS Indicators Monitoring System (SIERP).	<p>The final design of the scheme must be as agreed with the PRS, approved by the Social Cabinet, arrangements, technical details, and coordination with other relevant agencies for consultation and dissemination, as described in the proposal.</p> <p>A PRS indicators monitoring system must be submitted, approved by the Social Cabinet, containing:</p> <ul style="list-style-type: none"> (i) an evaluation of the PRS indicators information and (ii) a monitoring scheme
	Consulting services must have been contracted to develop the Integrated Bank of Projects for the Public Sector Investment System (BIP-SISPU) for monitoring PRS programs and projects throughout the project cycle.	The final design of the scheme must have been submitted, and must be functional by means of the project cycle.
	<p>Interinstitutional agreements must have been signed to provide the information needed to create the following consolidated databases:</p> <ul style="list-style-type: none"> (i) the PRS Indicators Monitoring System (SIERP); and (ii) the SEFIN databases for physical and financial monitoring and for monitoring the 	<p>Reports must have been produced by the</p> <ul style="list-style-type: none"> (i) the status of PRS of 2001; and (ii) monitoring of physical and financial progress of the PRS program produced by the

	PRS programs' project cycle.	
Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty R (HO-0185) Policy Matrix		
Objective	Conditions for the first tranche	Conditions
COMPONENT II: PRS FINANCIAL INSTRUMENTS		
Subcomponent 2.a: The Poverty Reduction Fund (FRP)		
To support creation of a financial facility that will provide a transparent mechanism for identifying the origin and destination of PRS funds.	A draft decree creating the Poverty Reduction Fund must have been submitted to the National Congress. This must contain at least the provisions stipulated in paragraph 2.38 of the loan proposal.	<p>The decree creating th must be in force.</p> <p>The FRP Regulations stipulated in paragraph in force.</p>
Subcomponent 2.b: Budgetary Management		
To support insertion of the PRS in the General National Budget, ensuring transparency in monitoring the PRS while maintaining budgetary flexibility.	<p>The Draft General National Budget for the year 2002 must identify PRS resources, ensure transparent monitoring of the source and application of funds through the establishment of budgetary allocations within specific programming structures, thereby eliminating the use of global allocations, including those for centralized services.</p> <p>The general provisions of the Draft General National Budget for 2002 must contain a rule requiring approval of budgets for the year 2002 for the decentralized and deconcentrated entities that are executing or will execute programs and projects included in the PRS, prior to the transfer of resources for financing those programs and projects.</p>	<p>The General National the year of disburseme the National Congress first tranche.</p> <p>The General Provision Budget for the year 20 must contain a rule rec year 2002 or for the y and decentralized insti programs and projects transferring funds to fi projects.</p>
		The budgets of the dec institutions executing l for the year of disburs resources, guarantee ti

		and application of those budgetary allocations, structures, and eliminating those for certain
Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction Strategy (HO-0185)		
Policy Matrix		
Objective	Conditions for the first tranche	Conditions
	<p>The process of regularizing approval of the budgets of decentralized and decentralized entities executing PRS programs must have been initiated, and SEFIN approval must have been obtained for the draft budgets for 2001, at least.</p> <p>The Social Cabinet must have approved and published eligibility guidelines for PRS programs and projects.</p>	<p>Budgets for the fiscal year 2001 must have been approved for the entities executing PRS programs transferred to those in the PRS framework.</p> <p>Semi-annual physical implementation of PRS execution must have been approved and expenditures can be met from the PRS of funding.</p>
COMPONENT III: INSTITUTIONALIZING CITIZEN PARTICIPATION		
To institutionalize participation by nongovernmental agents involved in monitoring PRS implementation.	The Decree creating the FRP must contain provisions for creation of the PRS Advisory Council, stipulating at least: the functions of the Council, the mechanisms for dissemination, coordination and articulation with other bodies at different levels, and its membership, to consist of representatives of the government, of civil society and observers from the donor community.	<p>The Executive Decree must be in force for the PRS Advisory Council.</p> <p>The Operating Regulation must be in force for minimum: (i) the process of implementation and (ii) operating procedures in the manner in which it is implemented.</p> <p>The PRS Advisory Council must be in force for the PRS Advisory Council.</p>

REPUBLIC OF HONDURAS

**Program Policy Letter:
Reforming the Institutional Framework and Creating Instruments for
Implementing the Poverty Reduction Strategy**

Tegucigalpa, M.D.C., August 7, 2001

Mr. Enrique Iglesias V.
President
Inter-American development Bank (IDB)
Washington D.C.

Dear Mr. President:

We are pleased to inform you that, in the wake of Hurricane Mitch and the negative impact on the country's productive apparatus and living standards, Honduras has stepped up its efforts to secure broad support from the international community in order to create an environment conducive to social well-being and the recovery of economic output. Significant efforts have been made in achieving these objectives, and the international community has responded promptly, thereby allowing a gradual improvement in the levels of economic growth.

In the context of the Master Plan for National Reconstruction and Transformation (PMRTN), one of the government's major activities, in cooperation with the international community and with the participation of civil society, has been to prepare a Poverty Reduction Strategy (PRS). Efforts are also being made to strengthen public administration in terms of security and the transparency of government actions. We have continued to support reforms in the social sectors and in the concessioning and privatization of public services, and to strengthen productive activities that can revive the country's principal export products and meet domestic consumption needs, especially in staple grains and other mass consumption products. Nevertheless, these efforts are still insufficient, given the fall in international prices for our export products, rising prices for oil and derivatives, and the deterioration in the public finances brought about by greater fiscal sacrifice and the sharp increase in health and education costs, reflecting the commitments undertaken through the adoption of a series of statutes that have expanded current public expenditure, and have provoked a decline in public saving, making it impossible to meet planned investment levels and increasing the fiscal deficit as a proportion of domestic output.

1. The characteristics of poverty

Related to the foregoing, and despite extensive government efforts to reduce poverty, Honduras is considered the third-poorest country in Latin America. Its poverty indicators

place the country below the average for the region: 66% of the Honduran population lives below the poverty line, and 75% of poverty is concentrated in rural areas. Even more dramatic is the fact that about 48.6% of the population is indigent, which means that it does not have the capacity to acquire the basic basket of goods. Despite the fact that there was some reduction in poverty during the past decade, the situation remains delicate and is being exacerbated by high levels of unemployment which cast a dark shadow over the security of our people.

The illiteracy rate remains high: in 2000, it stood at 19.6% of the population over 15 years. The supply of drinking water has improved, but 19% of the population still lacks such access, and 28.8% lacks sewage services. There is still a significant housing shortage, estimated at 342,000 new units. Despite the progress in reducing infant mortality, the rate still stands at 33 deaths for every 1,000 live births, although the vaccination rate for children under 5 has been improved, and is calculated at 94.2%. In light of these indicators, the country's Human Development Index (HDI), at 0.653, places Honduras 113 among the 174 countries in the world.

The macroeconomic framework

Since 1990, Honduras has made progress in stabilizing its economy and in undertaking structural reforms conducive to sustained economic growth. During the year 2000, Honduras recorded a significant economic recovery, with a growth rate of 4.8%, together with a decline in the average annual inflation rate, which at 10.1% was the lowest since 1993.

Despite the deterioration in the country's terms of trade in 2000, reflecting the substantial increase in oil prices and the fall in coffee prices, rising capital account flows, resulting both from foreign investment and from external disbursements, served to strengthen the country's external position by augmenting the international reserves of the Central Bank to the equivalent of four months' imports. Despite the Government of Honduras's efforts to strengthen the public finances, the Central Government closed the year with a deficit of 4.6% of GDP. For the biennium 2001-2002, the Central Government deficit will be about 4.5% and 2.5%, respectively, of GDP. Although the deficit will decline, PRS expenditures will rise, once financing is in hand.

According to preliminary statistics, the Honduran economy will continue to be faced with an unfavorable external environment over the period 2001-2002. Falling export prices and a slowdown in the economy of its principal trading partner, the United States, will affect export revenues, and this, together with rising imports, will increase the current account deficit from 3.9% of GDP in 2000 to about 5.2% in 2001-2002.

The Government of Honduras will continue its efforts to maintain fiscal discipline by improving tax administration, adjusting the public payroll and rationalizing public expenditure. As part of these efforts it will proceed further with redirecting public expenditure towards areas of greatest efficiency and towards the social sectors. Social

spending has in fact increased in recent years, and now accounts for 40.7% of total spending.

While Honduras benefited from debt relief in the context of Paris Club negotiations and debt service financing by the Central American Emergency Trust Fund (CAETF) in 2000, the country has so far received only a portion of the interim debt relief envisioned in the HIPC initiative, inasmuch as some financial institutions have been late in giving effect to the initiative.

The time lag in the receipt of proceeds from debt relief has increased pressure on the Government of Honduras finances during 2001, and has reduced the resources available for poverty reduction programs. According to preliminary estimates, this situation will lead to a PRS financing gap of US\$33.9 million in 2001 and US\$82.5 million in 2002, most of which will be covered by external financing. A shortfall in resources for financing the PRS would jeopardize the country's chances of reaching the HIPC completion point since, as noted earlier, Honduras is required to make progress in executing social programs and in implementing the PRS for at least one year.

Funding under the proposed program will help to consolidate the country's external position, while providing financing for priority social programs and thereby supporting implementation of the PRS during 2001 and 2002.

From the foregoing it will be appreciated that there are still significant social demands that have yet to be met, and that will require an acceleration in the productive apparatus to raise levels of social well-being by reducing social and financial deficits. In this respect, resources from the present program will help to consolidate the country's external position, while providing financing for priority social programs and thereby supporting implementation of the PRS during 2001 and 2002.

The Poverty Reduction Strategy (PRS)

To tackle the enormous problems of poverty, the government has designed a Poverty Reduction Strategy that sets out wide-ranging strategic guidelines and defines policy measures and a portfolio of programs and projects targeted at programming areas of national interest. As well, priority will be given to reducing poverty rather than alleviating its impact, to strengthening governance and participatory democracy, protecting the environment and mitigating disasters. Consistent with these guidelines, government interventions will involve programs and projects to reduce poverty in rural and urban areas, to invest in human capital, to support specific groups, with due regard to gender considerations, and to stress equitable and sustainable economic growth.

To finance the activities contained in the PRS, the government has undertaken intensive efforts to consolidate the strategy and to make further progress towards reaching the completion point under the Highly Indebted Poor Country Debt Relief Program (HIPC). The decision point under this facility was reached in June 2000, and thanks to progress with

economic management and structural reforms, the country has begun to receive financial support through interim debt relief. We expect that next year will see fulfillment of the conditions for the country to reach the completion point and to benefit from full debt relief. The resources to be generated will be channeled entirely to financing PRS programs and projects.

Implementing the PRS

First, however, we must have the required technical and legal instruments and other institutional arrangements in place. The legal documentation has been completed for creating the Poverty Reduction Fund as a financial facilitator for a duration of 15 years, which will allow for transparent monitoring in the raising and channeling of financial resources for implementing projects, in order to meet the PRS goals and objectives. We expect during the current year to organize the institutional and operational framework and to approve the Decree creating the Fund, and its regulations. We also expect to establish a database for evaluating physical and financial progress and for monitoring the indicators established for measuring poverty.

We believe, Mr. President, then while we are heading into an electoral campaign that will strengthen our democracy, this should constitute no impediment to continuing with our pragmatic actions for establishing an institutional framework that will guarantee implementation of the PRS. In this respect, we shall make every effort to ensure that the program in support of reforming the institutional framework and creating instruments for implementing the PRS will suffer no delays in its execution, since it is only by applying all of its components that we will be able to achieve the planned objectives, thereby increasing the efficiency and the effectiveness of the PRS in a fully transparent environment.

This program is intended to help with implementation of the PRS by fostering conditions for creating a macroeconomic framework that will protect spending for poverty-targeted programs and support the creation of an institutional framework that will allow for sound decision-making in allocating resources with a horizontal and transparent focus, creating mechanisms for monitoring the PRS indicators, supporting the creation of financial instruments needed to channel the proceeds of debt relief, and in this way to contribute to developing schemes that will allow civil society to participate in implementing the PRS. This sector program is organized in three components.

?? Creating an institutional and instrumental framework for implementing the PRS

This includes measures needed to create and consolidate the institutional and instrumental scheme for formulating, monitoring and evaluating social policies in line with the PRS. This component will define the institutional changes needed to implement the PRS; design the instruments needed for monitoring its programs and for measuring progress in implementing poverty reduction policies in order to meet the strategy's goals; organize decision-making in

the allocation of resources based on consultation between ministries and with civil society; and create the means for publicizing the use of PRS resources.

As well, the government will make efforts to use existing entities and so avoid the creation of new institutions that would give rise to higher operating costs. The government undertakes to finance the PRS Analysis Team, to assist the Social Cabinet in the annual programming of programs and projects and for monitoring poverty indicators under the PRS.

The government has set forth its commitments in the PRS paper, in the form of specific indicators and targets to be achieved by the year 2015. The objective is to design and implement an institutional and instrumental scheme for collecting information to be used in monitoring the poverty indicators agreed in the context of the PRS, and for monitoring physical progress with PRS programs and projects. A system of poverty indicators will therefore be developed and evaluated, and an organizational structure will be created to provide feedback from these indicators into the system for prioritizing expenditure, so as to improve the formulation of social policies.

The PRS financial instruments

To provide financial backing for the PRS, the government has decided to create a Poverty Reduction Fund (FRP), with a limited life of about 15 years, that will ensure transparency in raising, channeling and allocating the funds to be used in the PRS programs and projects. FRP resources will be used in accordance with guidelines from the Social Cabinet, and will be consistent with the budgetary procedures established by the Ministry of Finance. Funds for constituting the PRS will be derived from: (i) forgiveness of external debt service payments, under the HIPC initiative; (ii) proceeds to the central government from the sale, concession or other form of transfer of public goods to private parties, donations and concessional funds earmarked for relieving poverty. The FRP will also be used to finance: (i) PRS measures, programs and projects declared eligible by the Social Cabinet; (ii) expenses incurred by the responsible entities in project inspection, monitoring and evaluation of indicators, as well as monitoring of budgets and of physical and financial progress under the PRS.

Aware of the need to identify budgetary allocations for the PRS and their use, amendments will be made to the national budget to allow for allocation, execution and monitoring of PRS resources. For these purposes, SEFIN will make the needed changes in budgetary management so that PRS programs can be monitored, by program and by source of financing. This will make it possible both to generate the required information on progress with PRS project execution and to control the use of funds earmarked for the FRP. In this connection, we are grateful for the nonreimbursable technical cooperation that has been provided in support of efforts to strengthen SEFIN's budgetary management.

To ensure closer linkage between the PRS and the budget, we will continue our efforts to identify funding for the PRS within the national budget for the fiscal year 2002, and will

ensure transparent monitoring of the source and application of funds by establishing budgetary allocations within specific programming structures, and eliminating the use of global allocations including those for centralized services. As well, we will begin the process of regularizing the approval of budgets for deconcentrated and decentralized entities that are executing or will execute PRS programs and projects.

Consequently, the general provisions of the draft national budget will include a rule requiring the approval of budgets for the year 2002 before transferring funds to PRS finance programs and projects. Together with these budgetary monitoring efforts, we will publish semi-annual reports on physical and financial progress in executing the PRS, thereby allowing expenditure to be monitored by program and by source of funding.

?? Institutionalizing citizen participation

This component seeks to institutionalize participation by nongovernmental agents involved in implementing the PRS, by creating a PRS Advisory Council as established in the Legislative Decree creating the FRP. The Council will be comprised of representatives of the government and of civil society. It will be chaired by the President of the Republic or by the person responsible for coordination of the Social Cabinet. One of the government representatives will be the Minister of Finance. On behalf of civil society, there will be one representative appointed by the Association of Municipalities of Honduras (AMHON) and three representatives appointed by civil society organizations through a participatory process. Two representatives of the international financial community, proposed by multilateral and bilateral agencies, will be invited to attend Council meetings as observers.

Generally speaking, the Council's function will be to advise the Social Cabinet on matters relating to the identification, eligibility and prioritization of programs and projects. It will also recommend steps relating to management of the PRS, monitoring, participation of civil society, and the publication of information. Members of the Advisory Council will perform their duties *ad honorem*; they will meet at least once every two months, or whenever convened by its chair.

The Government of Honduras will submit a final report on the Poverty Reduction Strategy before or at the time the loan document is distributed to the IDB's Board of Executive Directors.

Finally, we wish to reconfirm that the Government of Honduras is committed to executing the Poverty Reduction Strategy and hopes to facilitate execution of the program contained in this policy letter, and we are confident that, with the Bank's support and that of other institutions and governments interested in supporting our country's social sector, we will be able to meet the objectives laid out in the PRS.

With assurances of our highest consideration and esteem.

(Original signed)

GUSTAVO A. ALFARO Z.
Minister of the Presidency and
Coordinator of the Social Cabinet

(Original signed)

GABRIELA NUÑEZ DE REYES
Minister of Finance and Governor
of the IDB for Honduras

**Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction
(HO-0185)**

Table of conditionality and means of verification for the first and second tranches

Objective	Conditions for the first tranche	Means of verification	Conditions for the second tranche
To maintain stability and economic growth conducive to the execution of poverty reduction programs.	To maintain a macroeconomic setting consistent with the objectives of the program.	Bank evaluation.	To maintain a macroeconomic setting consistent with the objectives of the program.

COMPONENT 1: CREATING AN INSTITUTIONAL AND INSTRUMENTAL FRAMEWORK FOR IMPLEMENTATION

Subcomponent 1.a: Technical Support to the Social Cabinet

To support the Social Cabinet by creating an institutional framework that will provide it with the technical support needed for decision-making.	Institutional mechanisms must have been designed, including creation of an interinstitutional technical team, for programming and prioritizing PRS programs and projects in such a way as to ensure coordination among the various institutions involved in implementing the PRS.	A proposal as to how the interinstitutional technical team is to be established and a draft manual describing how the institutional mechanisms proposed in the design are to be implemented.	The interinstitutional technical team must have been established and the operations manual for giving effect to the institutional mechanisms proposed in the design must have been approved.
			PRS programs and projects must have been programmed and prioritized, on the basis of the coordination mechanisms developed under the first tranche.
	The SDP must have established a PRS analysis team (EDA) with the analytical and information - processing capacities to provide technical support to the Social Cabinet, with, as a minimum, the functions described in paragraph 2.16 of the loan proposal.	Certification by the Minister of the Presidency (SDP) that professionals have been appointed to the PRS analysis team, including a description of the functions of each professional, and every report containing a training plan for the team.	The PRS Analysis Team must be operating within the SDP.
	A system must have been designed for publicizing information at the central and municipal levels on the allocation of PRS resources, the performance of PRS indicators, and the progress achieved under its programs and projects.	Final design report.	The public dissemination system must be in operation.

Subcomponent 1.b: Instrumental aspects, consolidated database

To design and implement an instrumental scheme for	The technical counterpart of the SDP must have been designated and	i) Present final terms of reference for contracting consulting firms or	The final design of the SIERP must have been submitted, as agreed with the PRS
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Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction Fund (HO-0185)

Table of conditionality and means of verification for the first and second tranches

Objective	Conditions for the first tranche	Means of verification	Conditions for the second tranche
monitoring the indicators agreed in the context of the PRS and physical and financial progress with PRS programs and projects.	consultants identified to work with this team to develop the PRS Indicators Monitoring System (SIERP).	individual consultants; ii) A list of three to six qualified firms/consultants; and iii) Designation of the technical counterpart responsible for monitoring the SIERP design.	Advisory Council and approved by the Social Cabinet, containing institutional arrangements, technical bases, mechanisms for coordination with other donors, as well as mechanisms for consultation and dissemination of the reports produced, as described in paragraph 2.26.
			A PRS indicators monitoring plan must have been submitted, approved by the Social Cabinet and containing: (i) an evaluation of the methodology for collecting information and validating its quality; and (ii) a monitoring schedule.
	Consulting services must have been contracted to develop the Integrated Bank of Projects for the Public Sector Investment System (BIP-SISPU) for monitoring PRS programs and projects throughout the project cycle.	Contracts signed with the consultants.	The final design of the BIP-SISPU system must have been submitted, and must have been shown to be functional by means of a pilot experiment.
	Interinstitutional agreements must have been signed to provide the information needed to create the following consolidated databases: (i) the PRS Indicators Monitoring System (SIERP); and (ii) the SEFIN databases for physical and financial monitoring and for monitoring the PRS programs' project cycle.	Agreements signed between SDP, SEFIN, Ministry of Education; Ministry of Health; Honduran Fund for Social Investment; Honduran Institute for Children and the Family; Technical Secretariat for International Cooperation; Ministry of Agriculture and Livestock; Ministry of Public Works, Transport and Housing; and National Statistics Institute.	Reports must have been submitted to the Social Cabinet on: (i) the status of PRS indicators during the second half of 2001; and (ii) monitoring of physical and financial progress under the PRS programs, based on the information produced by the SEFIN.

COMPONENT II: PRS FINANCIAL INSTRUMENTS

Subcomponent 2.a: The Poverty Reduction Fund (FRP)

To support creation of a financial facility that will provide a transparent	A draft decree creating the Poverty Reduction Fund must have been submitted to the National Congress.	The draft decree creating the FRP and the transmittal note from SEFIN to Congress.	The decree creating the Poverty Reduction Fund (FRP) must be in force.
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**Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction
(HO-0185)**

Table of conditionality and means of verification for the first and second tranches

Objective	Conditions for the first tranche	Means of verification	Conditions for the second tranche
mechanism for identifying the origin and destination of FRP funds.	This must contain at least the provisions stipulated in paragraph 2.38 of the loan proposal.		
			The FRP Operating Regulations containing at least the item stipulated in paragraph 2.39 of the loan proposal must be in force.

Subcomponent 2.b. Budgetary Management

To support insertion of the PRS in the General National Budget, ensuring transparency in monitoring the PRS while maintaining budgetary flexibility.	The Draft General National Budget for the year 2002 must identify PRS resources, ensure transparent monitoring of the source and application of funds through the establishment of budgetary allocations within specific programming structures, thereby eliminating the use of global allocations, including those for centralized services.	Transmittal note to Congress for the Draft General National Budget. Draft General National Budget for 2002. Consolidated budget annex for the PRS submitted to Congress showing program structures, disaggregated by the individual expenditure line to which PRS budgetary appropriations have been allocated. Draft General Budget Provisions for 2002, prohibiting use of the item "global allocations", including that for "centralized services" for PRS programs.	The General National Budget for the year 2002, or for the year of disbursement, must have been approved by the National Congress under the terms stipulated for the first tranche.
	The general provisions of the Draft General National Budget for 2002 must contain a rule requiring approval of budgets for the year 2002 for the decentralized and deconcentrated entities that are executing or will execute programs and projects included in the PRS, prior to the transfer of resources for financing those programs and projects.	Draft General Budget Provisions including a rule requiring approval of the 2002 budgets for deconcentrated and decentralized institutions before transfer of funds to finance PRS programs and projects.	The General Provisions governing the General National Budget for the year 2002 or for the year of disbursement must contain a rule requiring approval of budgets for the year 2002 or for the year in which the deconcentrated and decentralized institutions execute or would execute programs and projects included in the PRS, before transferring funds to finance those programs and projects.
			The budgets of the deconcentrated and decentralized institutions executing PRS

**Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction
(HO-0185)**

Table of conditionality and means of verification for the first and second tranches

Objective	Conditions for the first tranche	Means of verification	Conditions for the second tranche
			programs for the year 2002 or for the year of disbursement must identify PRS resources, guarantee transparent monitoring of the source and application of those resources, by establishing budgetary allocations within specific programming structures, and eliminating the use of global allocations, including those for centralized services.
	The process of regularizing approval of the budgets of deconcentrated and decentralized entities executing PRS programs must have been initiated, and SEFIN approval must have been obtained for the draft budgets for 2001, at least.	Certification from SEFIN that the draft 2001 budgets for deconcentrated and decentralized entities executing PRS programs have been approved.	Budgets for the fiscal year of disbursement must have been approved for the deconcentrated and decentralized entities executing PRS programs, before PRS funds are transferred to those institutions.
	The Social Cabinet must have approved and published eligibility guidelines for PRS programs and projects.	Record of Social Cabinet decision improving the guidelines. Guidelines published on the web page.	Semi-annual physical and financial progress reports on PRS execution must have been published, so that expenditures can be monitored by program and by source of funding.

COMPONENT III: INSTITUTIONALIZING CITIZEN PARTICIPATION

To institutionalize the participation of nongovernmental agents in monitoring PRS implementation.	The Decree creating the FRP must contain provisions for creation of the PRS Advisory Council, stipulating at least: the functions of the Council, the mechanisms for dissemination, coordination and articulation with other bodies at different levels, and its membership, to consist of representatives of the government, of civil society and observers from the donor community.	Draft Legislative Decree for the FRP creating the Advisory Council, with the characteristics mentioned in the condition.	<p>The Executive Decree creating the PRS Advisory Council must be in force.</p> <p>The Operating Regulations for the PRS Advisory Council must be in force, and must contain as a minimum: (i) the procedure for appointing its members; and (ii) operating procedures for the Council, including the manner in which its executive will function.</p> <p>The PRS Advisory Council must have begun operations.</p>
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